Division Economic Development and Employment
Sector Project Financial Systems Development

Islamic Microfinance in Indonesia

commissioned by

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Indonesian macroeconomic data, 2001-2003

	2001	2002	2003
GDP growth rate	3.5	3.7	4.1
Population (millions)	208.9	212.0	215.2
Percentage of poor			17.4
GDP per capita in US $	685	815	969
Inflation rate (CPI) in %	12.6	10.0	5.1
Exchange rate to the US$: average	10,255	9,318	8,572
Exchange rate (median) to the US$: end of year	10,446	8,938	8,451
Financial deepening (M2/GDP) in %	57.5	54.9	53.5
Average bank lending rate in % (working capital credit only):	19.19	18.25	15.07
Average bank deposit rate (one-month fixed deposits) in %	16.07	12.81	6.62
SBI (one-month) rate [TB rate]	17.62	12.93	8.31

USD/IDR exchange rates, 1992-2004

	Year-end	Year average
1992	2,067	2,033
1993	2,102	2,089
1994	2,199	2,163
1995	2,287	2,247
1996	2,344	2,329
1997	3,646	2,776
1998	8,000	10,248
1999	7,100	7,787
2000	9,675	8,527
2001	10,400	10,271
2002	8,940	9,318
2003	8,451	8,572
2004*	9,249	

* as of 31 May 2004

Note on transcriptions:
Key Islamic banking terms are based on Islamic law and written in Arabic. Transcriptions vary widely in Indonesia and elsewhere; there is no authoritative standard of transcription. In sub-section 2.3, the key terminology is therefore presented in Arabic, the most common international transcription, and widely used transcriptions as used in Indonesia. For example, there are the various transcriptions of the term for Islamic law: شريعة , shar'iah, Syariah or sharia. The Arabic terms and international transcriptions have been provided by Dr. Omar Imady, Damascus.

Abstract

Islamic Microfinance in Indonesia

Indonesia, the largest Muslim country in the world, has a highly complex microfinance and rural finance sector which has evolved over more than a century. Islamic finance has emerged in 1991, comprising Islamic commercial banks and banking units, rural banks, and financial cooperatives. In this study we examine the emerging Islamic microfinance sector in Indonesia, particularly rural banks and financial cooperatives, assessing how they have evolved, how they compare with conventional institutions, and what their prospects are for growth.

Islamic finance, despite 13 years of existence, accounts for a mere 0.74% of the total assets of the banking sector. However, since Bank Indonesia officially recognized a dual banking system, conventional and Islamic, in 1988, interest in Islamic meso and macro finance has spread among commercial banks, fuelled by low rates of non-performing loans. Over the period 2001-2003 the share of Islamic commercial banks increased from 0.17% to 0.74%.

Islamic rural banks (*Bank Perkreditan Rakyat Syariah*, BPRS) operate under the same effective prudential regulation and supervision as commercial banks and conventional rural banks (BPR). After a promising start in the early 1990s, their development has since almost come to a standstill. Despite the fact that they have had only two years less than conventional BPR, they now comprise a mere 4% of the total number of rural banks, and 1.5% of the assets of the rural banking sector. Many investors are absentee owners acting out of moral commitment, who leave the management to retired commercial bankers who lack the requisite skills.

Islamic financial cooperatives (*Baitul Maal wat Tamwil*, BMT) suffer from the same regulatory and supervisory neglect as the rest of the sector. After a period of rapid growth during much of the 1990s, they are now in decline, with perhaps no more than one-fifth in good health. Fresh money pumped into the sector without effective regulation and supervision will contribute to their downfall, as has been the case in the state-supported cooperative sector.

Islamic financial products have little appeal for either the banks or their customers. They are complicated and poorly understood. Most of the lending is trade financing at a fixed margin (*Murabahah*), which differs little from conventional banking, except that it requires two bank contracts: one with the seller, and one with the borrower to whom the bank sells the commodity. The strength of Islamic finance lies in its conservative character: only real transactions with sufficient collateral are financed, and not speculative investments. This however means that financing for start-ups and micro-entrepreneurs without collateral is effectively kept to a minimum.

Assessment: Islamic microfinance, given the lack of popular demand and Islamic banking expertise, so far has been more a political than an economic project in Indonesia. Only commercial banks appear capable of acquiring the art of Islamic banking by training young and dynamic people; however, most lack experience in microfinance. Islamic, unlike conventional, rural banks have failed to prove themselves as effective and efficient providers of microfinance services; and unsupervised Islamic cooperatives, like their conventional counterparts, are an outright menace to their shareholders and depositors, who risk losing their money. On the basis of 13 years of experience with Islamic finance in Indonesia, decision-makers in favor of promoting Islamic financial services are now confronted with two major options, either:

- to focus on Islamic commercial banks in Indonesia and assisting them to establish branch networks with Islamic microfinance products; or
- to reassess in a participatory process the challenges and realistic opportunities offered by Islamic rural banks and cooperatives, taking into consideration the lack of broad popular demand, be it from the poor or the non-poor, and the lack of dynamic growth.

Recommendations: We recommend that decision-makers in Islamic organizations, government agencies and donor organizations should cautiously examine the following opportunities which could lead to the development of a healthy Islamic financial sector in Indonesia:

1. **Commercial banks,** by setting up branch networks of Islamic MFIs, may profitably learn from the rich experience of successful microfinance strategies and institutions within Indonesia, particularly the Bank Rakyat Indonesia (BRI) Microbanking Division, one of the most successful microfinance programs in the developing world.

2. **Islamic rural banks** need to be revamped if they are to play more than a marginal role in Indonesia. This will require an overall development plan for the BPRS sector to be formulated that has been mutually agreed upon by all stakeholders, coupled with a strong banking association to provide a full range of support services to its members. Some of the more successful Islamic rural banks may serve as exposure training sites for future managers. Auditing should be mandatory regardless of size.

3. **Islamic cooperatives** suffer from much the same set of problems as the whole cooperative sector. There is little chance of any intervention being successful in the short run, except in a limited area. They need a system of prudential regulation, mandatory auditing and effective supervision by an appropriate financial authority. They should be fully financed through equity and savings deposits of members; only healthy and well-supervised cooperatives should be permitted to collect deposits from non-members. They need strong associations and federations to provide a full range of support services to their members.

Postscript: Islamic finance in the province of Aceh after the tsunami:
Of all the areas devastated by the tsunami of 26 December 2004, the province of Aceh has been hardest hit. Providing relief and reconstructing the livelihoods of the surviving victims is the immediate task; reconstructing the physical and institutional infrastructure will have to come later. If the reconstruction efforts are to lead to sustainable development, rural finance and microfinance will have an important role to play. The people of Aceh adhere strongly to the principles of Islam, including those of Islamic finance; the taking or charging interest (*Riba*) is against their religious convictions. Building strong Islamic financial institutions in Aceh could be of enormous benefit to the reconstruction and development of the province, and Aceh could as a result be the province that benefits the most from the results of this study.

Kurzfassung

Islamische Mikrofinanzinstitutionen in Indonesien

Indonesien, das größte islamische Land, verfügt über einen hoch differenzierten Mikrofinanzsektor, insbesondere auch in ländlichen Gebieten, dessen Geschichte sich über mehr als ein Jahrhundert erstreckt. Seit 1991 entwickelt sich nun ein islamisches Finanzwesen. Dieses umfasst Geschäftsbanken, ländliche Banken (*BPR*) und Genossenschaften. Gegenstand dieser Studie ist der im Entstehen begriffene islamische Mikrofinanzsektor, insbesondere ländliche Banken und Genossenschaften: ihre bisherige Entwicklung, auch im Vergleich zu konventionellen Institutionen, und ihre Wachstumsaussichten.

Islamische Finanzinstitutionen belaufen sich nach dreizehnjähriger Geschichte auf nur 0,74% sämtlicher Bankaktiva. Seit 1998 erkennt Bank Indonesia, die Zentralbank, ein duales Bankwesen konventioneller und islamischer Institutionen an. Zusammen mit einer niedrigen Rate an Kreditausfällen bei den islamischen Geschäftsbanken hat dies dazu geführt, dass sich ihr Anteil an den Bankaktiva im Zeitraum 2001-2003 von 0,17% auf 0,74% vervierfacht hat; die Anteile bleiben bei Einschluss der ländlichen Banken unverändert.

Islamische ländliche Banken (BPRS) unterliegen der gleichen Regulierung und Aufsicht wie Geschäfts- und konventionelle ländliche Banken (BPR). Nach einem hoffnungsvollen Start 1991 ist ihre Entwicklung fast zum Stillstand gekommen. Obwohl sie nur zwei Jahre nach den ersten konventionellen ländlichen Banken entstanden sind, belaufen sich ihre Aktiva nur auf 1,5%, ihre Zahl auf 4% der ländlichen Banken. Viele Investoren sind Absenzeigner, die Gutes tun wollen und das Bankgeschäft pensionierten Geschäftsbankangestellten mit unzureichender Eignung überlassen.

Islamische Spar- und Kreditgenossenschaften (BMT) leiden unter demselben Mangel an Regulierung und Aufsicht wie der übrige Genossenschaftssektor. Nach rascher Expansion in den 90er Jahren ist ihre Entwicklung nun rückläufig; nur ein Bruchteil gilt als solvent. Zusätzliche Finanzmittel ohne ausreichende Regulierung und Aufsicht würden nur zu ihrem weiteren Rückgang beitragen, wie das bei dem staatlich geförderten Genossenschaftssektor der Fall gewesen ist.

Islamische Finanzprodukte haben sich als wenig attraktiv erwiesen, für die Banken wie für ihre Kunden. Sie sind kompliziert und vielen unverständlich. Der größte Teil des Kreditgeschäfts besteht in Handelsfinanzierungen zu einem festen Aufschlag (*Murabaha*) und unterscheidet sich nur wenig von konventionellen Krediten, außer dass jeweils zwei Verträge erforderlich sind: einer mit dem Lieferanten, von dem die Bank die Ware erwirbt, und einer mit dem Enderwerber und Kreditnehmer. Eine Stärke des islamischen Finanzwesens besteht in seinem konservativen Charakter: nur reale, ausreichend abgesicherte Transaktionen werden finanziert, keine Spekulationsgeschäfte. Allerdings

reduziert dies Kredite für Unternehmensgründer und Kleinunternehmer ohne Sicherheiten auf ein Minimum.

Bewertung: Das islamische Mikrofinanzwesen in Indonesien leidet an einem Mangel an breiter Nachfrage und islamischer Bankkompetenz; es ist eher ein politisches als ein wirtschaftliches Projekt. Nur Geschäftsbanken scheinen in der Lage zu sein, jungen dynamischen Mitarbeitern die Kunst des islamischen Bankgeschäfts zu vermitteln; die meisten verfügen aber nicht über die erforderliche Mikrofinanzerfahrung. Islamische ländliche Banken haben sich im Gegensatz zu konventionellen ländlichen Banken nicht als effektive und effiziente Finanzdienstleister erwiesen. Islamische wie auch konventionelle Genossenschaften ohne funktionierende Aufsicht stellen eine Bedrohung für Mitglieder und Sparer dar. Entscheidungsträger sehen sich nach dreizehnjähriger Erfahrung nun zwei Optionen gegenüber: (a) sich entweder auf islamische Geschäftsbanken zu konzentrieren und sie bei der Einführung islamischer Mikrofinanzabteilungen und -produkte zu unterstützen; (b) oder in einem partizipatorischen Prozess die Herausforderungen und realen Chancen islamischer ländlicher Banken und Genossenschaften einer Neubewertung zu unterziehen, unter Berücksichtigung des Mangels an breiter Nachfrage und an Wachstumsimpulsen.

Empfehlungen: Islamische Organisationen, Regierungsstellen und Geber sollten die folgenden Ansatzmöglichkeiten für die Entwicklung eines gesunden Islamischen Finanzsektor in Indonesien einer abwägenden Prüfung unterziehen:

1. Geschäftsbanken, die ein Zweigstellennetz mit islamischen Mikrofinanzdienstleistungen aufbauen wollen, sollten auf der reichhaltigen Mikrofinanzerfahrung Indonesiens aufbauen, insbesondere der Microbanking Division der Bank Rakyat Indonesia, einem der erfolgreichsten Mikrofinanzprogramme in Entwicklungsländern.

2. Der Subsektor islamischer ländlicher Banken bedarf einer gründlichen Reform, wenn er mehr als eine marginale Rolle in Indonesien spielen soll. Dazu ist ein umfassender, mit allen Beteiligten abgestimmter Entwicklungsplan erforderlich, ferner ein leistungsfähiger Verband zur Unterstützung seiner Mitglieder. Einige der erfolgreicheren islamischen ländlichen Banken können dabei zu Ausbildungsinstitutionen für zukünftige Bankmanager ausgebaut werden. Sämtliche Banken sollten der Bankenaufsicht unterliegen, unabhängig von der Größe.

3. Islamische Genossenschaften leiden unter denselben Regulierungs- und Aufsichtsproblemen wie der gesamte Genossenschaftssektor. Die Aussichten für kurzfristig erfolgreiche Interventionen sind gering, außer in eng umgrenztem Raum. Die Genossenschaften benötigen dringend eine adäquate Regulierung und ein funktionierendes Prüf- und Aufsichtswesen. Sie sollten sich voll aus Beteiligungen und Ersparnissen der Mitglieder finanzieren. Der Aufbau eines leistungsfähigen Verbandswesens ist dringend erforderlich.

Postscriptum:

Aufbau Islamischer Mikrofinanzinstitutionen in der Provinz Aceh nach dem Tsunami

Die Zerstörungen des Tsunami im Dezember 2004 haben am stärksten die Provinz Aceh in Indonesien getroffen. Auf die unmittelbare Nothilfe muss die Hilfe zum Wiederaufbau der physischen und institutionellen Infrastruktur folgen. Für eine nachhaltige Entwicklung ist ein leistungsfähiges Mikrofinanzwesen unabdingbar. Die Bevölkerung der Provinz Aceh fühlt sich in hohem Maße den Werten des Islam verpflichtet, darunter den Grundsätzen des islamischen Finanzwesens. Daher kommt der Förderung tragfähiger islamischer Finanzinstitutionen in Aceh große Bedeutung für den Wiederaufbau und die Entwicklung der Provinz zu. Die Ergebnisse dieser Studie könnten sich dabei als äußerst nützlich erweisen.

Introduction

Islamic banking based on Islamic law, sharia, started around 40 years ago. Few countries have adopted Islamic banking as their sole mode of operation; those that have include Iran and Sudan. Other predominantly Islamic countries have by contrast clearly avoided Islamic banking, while in some cases tolerating niches of Islamic microfinance as a concession to local cultures (e.g. Syria[1]). In recent years, Islamic banks, banking units and Islamic products have begun to emerge in an increasing number of countries in both the developed and the developing world. However, this growth has not been mirrored in the microfinance sectors of most countries with Islamic financial services. This can probably be attributed to Islamic banking principles such as partnership and profit-sharing with investors, which require adequate book-keeping and auditing, or, as an alternative, charitable credit to the poor without profit-sharing. As a result, the vast majority of the poor continue to be without access to finance in these countries.

Indonesia is the world's largest Muslim country. Islamic finance began here in 1991, comprising Islamic commercial banks, commercial banking units, rural banks, and financial cooperatives. Indonesia also has one of the most complex microfinance and rural finance sectors of all the developing countries, comprising both formal and non-formal financial institutions. In this study we examine the emerging Islamic microfinance sector in Indonesia, particularly rural banks and financial cooperatives, assessing how they have evolved, how they compare with conventional microfinance institutions, and what their prospects for growth are. The objective of this study is contribute to international awareness of Islamic microfinance by providing an overview of the characteristics and current practices of sharia institutions involved in providing financial services to poorer segments of the Indonesian population.

Field work in Indonesia, limited to western Java due to time constraints, was carried out between 24 May and 5 June 2004. The main sources of information were the Islamic banking directorate of Bank Indonesia; Asosiasi Bank Syariah Indonesia (ASBISINDO), the Islamic banking association; Pusat Inkubasi Bisnis Usaha Kecil (PINBUK), the agency for the promotion of Islamic cooperatives, the Ministry of Cooperatives and Small Enterprises (MoC), and case studies of five Islamic rural banks (BPRS) and four Islamic savings and credit cooperatives (BMT). It should be noted at this point that there is no reliable statistical information on Islamic cooperatives, quite in contrast to Islamic commercial and rural banks, which are supervised by the central bank. Other sources of information are listed in the references and in Annex 1. Logistical support was efficiently provided by the GTZ project on *Promotion of Small Financial Institutions (ProFI)*. We gratefully acknowledge these invaluable inputs and services.

The study has greatly benefited from the collaboration with Wahyu Dwi Agung, one of the early promoters of Islamic banking in Indonesia and head of ASBISINDO, who has freely provided his insights and contacts.

[1] Cf. Imady and Seibel 2003.

A note on the concept of microfinance

The concept of microfinance is somewhat ambiguous in Indonesia, as it has a series of different connotations in both a wider and a narrower sense. More generally, microfinance institutions (MFIs) include institutions of the formal, semiformal and informal financial sectors that provide small-scale financial services to the lower segments of the population. For example, there are the units of the BRI Microbanking Division and the BPR as part of the formal financial sector; various types of cooperatives and the so-called village banks (*bank desa*), which are part of the semiformal financial sector outside the regulation and supervision of the financial authorities; and a wide variety of self-help groups, channeling groups and rotating savings and credit associations (ROSCAs, known locally as *arisan*) as part of the informal financial sector.

In a narrower sense, microfinance institutions loosely comprise a variety of semiformal financial institutions targeted by the draft law of September 2001 on Lembaga Keuangan Mikro (LKM), which literally means microfinance institutions. A number of cooperatives, larger self-help groups and associations of smaller ones refer to themselves as LKM in anticipation of the law, even though the future of that law is uncertain. The draft law does not include the microfinance institutions of the formal sector such as the BRI units and the BPR which fall under the banking law. In this report, Islamic microfinance comprises sharia rural banks (BPRS) and sharia cooperatives (BMT, BTM).

1. Financial sector framework

1.1 Financial infrastructure

Indonesia has one of the most differentiated banking and microfinance sectors of any developing country. After the establishment of the first rural bank in 1895, a three-tiered financial system of national, district and village institutions evolved. At the top was a century-old agricultural bank, now known as Bank Rakyat Indonesia (BRI). At the community level were two types of village banks, specialized in banking-in-kind and banking-in-money. As early as 1910, there were over 13,000 rural banks, comprising 12,542 rice banks and 585 money banks. Since then, money has gradually replaced kind. After more than a hundred years of evolutionary growth, the banking sector now comprises 138 commercial banks with a total of 7,730 bank offices (excluding the BRI units); and 2,134 BPR. The rural and microfinance sector comprises 53,500 units, including 6,300 formal and 47,200 semiformal microfinance units (*see Appendix 1, Table 1*). Most notable among them are some 4,000 BRI units (formerly *unit desa*), arguably the developing world's most successful rural microfinance providers. They account for 74% of micro-savings and 39% of micro-loans. In addition, there are some 800,000 channeling groups and uncounted numbers of indigenous ROSCAs. In recent years new efforts have been made to extend the protection of the law to financial institutions of the poor and near-poor by preparing a draft law for MFIs, the LKM.[2] Despite the extraordinarily high level of institutional differentiation, large numbers of households are reportedly without access to formal or semiformal finance.

The Banking Law in Indonesia recognizes two types of banks: commercial banks (*Bank Umum, BU*, literally universal banks), and rural banks (*Bank Perkreditan Rakyat*, BPR, literally people's credit banks). **The commercial banking sector**, which nearly collapsed during the 1997/98 crisis, has recovered due to major consolidation efforts on the part of the government, which included numerous bank closures and mergers. From 1999 to 2003, the gross non-performing loan ratio (NPL) declined from 32.8% to 8.1%, and net NPL from 7.3% to 1.8%. During the same period, the banks went from losses of 7.5% to (pre-tax) profits of 2.1% of total assets; the capital adequacy ratio (CAR) went from –8.1% in 1999 to 20.7% in 2003. However, the overall growth of the commercial banking sector is still sluggish.

Rural banks (BPR), which are one of the two types of microfinance institutions dealt with in this study, are based on the law of 1988 (*PAKTO27*). They consist of newly established BPR (*BPR baru*) and former rural banks converted into BPR (*BPR lama*). In the context of financial liberalization, the law was enacted in an effort to rationalize the highly complex rural finance sector, with the objective of bringing existing institutions under the umbrella of prudential regulation and supervision, providing a framework for the establishment of

[2] Act XXX of 2001, draft dated 14/9/2001. This is a participatory effort coordinated by a Tim Inisiatif, first headed by Bank Indonesia and subsequently by a newly created microfinance unit in the MoA. The World Bank, the Asian Development Bank (ADB) and Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH have also been involved.

new financial institutions with private capital, and extending the outreach of financial institutions to the poorer sections of the rural and peri-urban population, thereby lessening their dependence on private moneylenders. Minimum capital requirements for BPR were uniformly set at Rp 50m, equivalent to US$ 29,000 in 1988 (US$ 21,000 in 1996 as a result of devaluation). Most of the newly established BPR were set up by private owners.

There were as of December 2003 2,134 licensed and regulated BPR. While they account for a mere 1.0% of total banking assets, their asset growth during the three years prior to 2003 has exceeded that of the commercial banking sector by a wide margin (*see Appendix 1, Table 2; and Appendix 2 ,Table 1)*). Over the last 15 years, BPR have expanded at widely differing rates in three main phases:

> **Phase 1:** During the initial five-year period, 1989-1993, BPR grew at an average number of 342 per year.
>
> **Phase 2:** Over the following six years, 1994-1999, growth slowed to 120 BPR per year.[3] However, it came as a surprise to many that the Asian financial crisis not only failed to impede further growth, but if anything, actually inspired further development, with 153 additional BPR established in 1997, 122 in 1998 and 165 in 1999 (averaging 147 per year during the three main crisis years). As observers have noted, “the BPR have come through the financial crisis in very good shape and are now reaching larger numbers of customers in a sustainable manner” (ADB 2003, Supplementary Appendix C, 6-7).
>
> **Phase 3:** 2000 marked a turnaround, initiating a consolidation period. The number of new BPR declined owing to increased minimum capital requirements, more rigid supervision by the central bank, the enforcement of performance standards and the closing of non-performing BPR. In the four-year period 2000-2003, the number of BPR decreased on average annually by 73. Up to 2003, Bank Indonesia had revoked the licenses of 193 BPR. Evidently, Bank Indonesia not only regulates but also effectively supervises the BPR, enhancing prudential banking and revoking licenses if banks do not comply.

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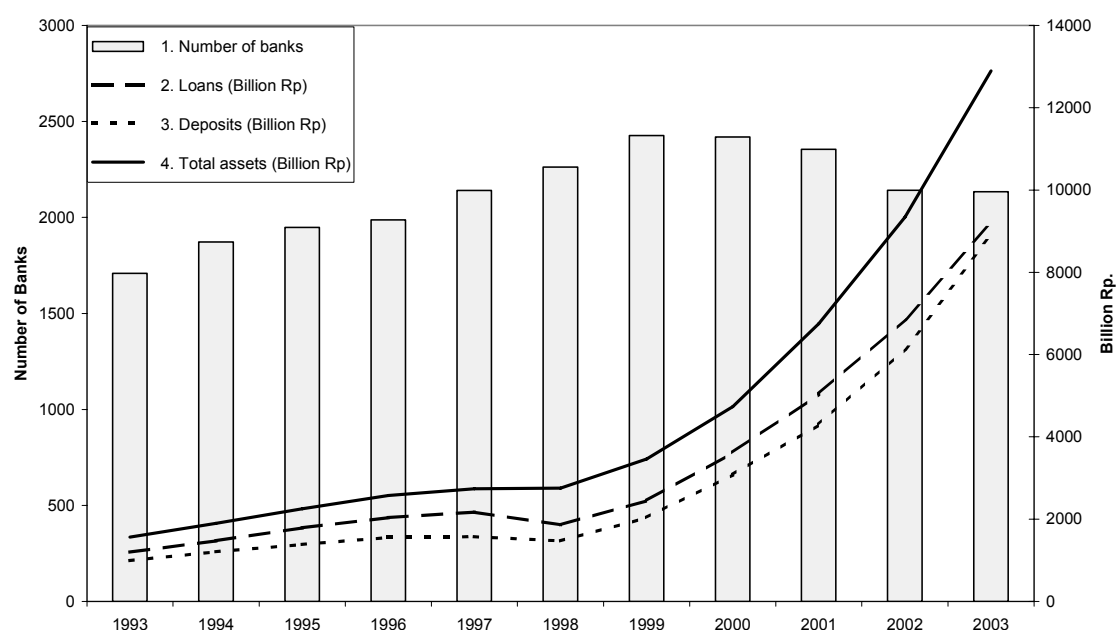
[3] The picture is complex, depending on whether we look at total numbers of BPR , numbers by origin, and total assets. There are three major types of new BPR: newly established institutions, converted conventional BPR, and converted other microfinance institutions. Unfortunately, the reported figures by origin do not conform to the overall figures on BPR reported above (see Appendix 2 Table 1) The following information on newly established and converted BPR is therefore only indicative. In 1990, 329 BPR had been newly established (56%), and 257 existing institutions (44%) had acquired a BPR license, bringing the total to 586 BPR. By 1992, the total number was 1,021: the number of new BPR had surged to 848 (83%), while the number of converted BPR had declined to 173 (17%), indicating that a good number of them were unable to live up to the Bank Indonesiastandards. During the eight-year period until the end of 1996, the total number of BPR had reached almost 2,000: 1,343 new BPR (68%) and 644 converted BPR3 (32%), totaling 1,987. The financial crisis brought the growth of the number of new BPR almost to a standstill; their total number continued to grow, but mainly through the conversion of existing *Lembaga Dana Kredit Pedesaan* (LDKP), previously under provincial law, into BPR under national banking law. By June 2002, the total number of BPR had grown to 2,213: 1,365 new BPR (62%) and 848 converted BPR (38%) [151 *Bank Pasar*/*Bank Desa*, 133 *Bank Karya Produksi Desa* (BKPD) and 564 LDKP]. Bank Indonesia has played a decisive role in closing poorly performing BPR and in assisting various MFIs in transforming themselves into BPR. By December 2003, the total number of BPR had declined to 2,134. (ADB Supplementary Appendix C: 6-7; Steinwand 2001: 172)

There are still large numbers of rural banks expected to comply with registration requirements and obtain a BPR license, but unable to come up with the required capital. 92 applications for new BPR are reportedly in the pipeline.

The shrinking numbers of BPR over the three years prior to 2003 presents a dismal picture. Yet, while numbers have shrunk, assets have grown rapidly, indicating an impressive performance during this period of consolidation, reaching total assets of Rp 12.90tr, or on average Rp 6.05bn or US$ 715,300 per BPR as of December 2003. During the three-year period from December 2000 to December 2003, their total assets grew by 173%, deposits by 189%, and credit by 154% – compared to growth rates of 11%, 25% and 49%, respectively, in the commercial banking sector.[4] Given an average annual inflation rate of 9.3% during that period, the growth rates of commercial banks were negative, while those of the BPR were strongly positive. In 2000, 2001 and 2002, BPR pre-tax profits stood at 2.5%, 3.3% and 3.6% respectively of total assets.

Graph 1.1: Development of rural banks, 1993-2003

Excess liquidity has been a major problem for the commercial banking sector in Indonesia. As of November 2003, banks had mobilized Rp 875.4tr (US$ 103bn) in deposits, but had lent only Rp 475.7tr (US$ 56bn), generating Rp 400tr (US$ 47bn) in excess liquidity. Indonesia's problem is how to lend, not a lack of funds. The loan-to-deposit ratio (LDR), while still low, has been improving in recent years, rising from 26.2% in 1999 to 43.7% in 2003. This problem also applies to the major rural and peri-urban microfinance provider, the BRI Microbanking Division. Since 1990, the BRI units have

[4] Inflation rates stood at 12.6% in 2001, 10.0% in 2002 and 5.1% in 2003, averaging 9.3% p.a. This means that real growth rates of total assets and deposits of the commercial banking sector were negative during that time period, while all three growth rates of the rural banking sector were highly positive in real terms.

produced large amounts of excess liquidity from rural savings, consistently exceeding US$ 1bn per year throughout and after the Asian financial crisis; as of December 2003, its LDR was 47.6%, close to the commercial banking average. There is thus little, if any, justification for donors to pour hard-currency liquidity into the national soft-currency intermediation circuit.

Table 1.1: Liquidity surplus or deficit in US$ and loan-to-deposit ratios (LDRs) of commercial banks and small financial institutions in Indonesia (BRI units 2003, others ~2000)

Type of institution	Deposits	Loans outstanding	Liquidity surplus*	LDR
Commercial banks	103bn	56bn	47bn	44%
BRI units	3.5bn	1.7bn	1.8bn	48%
Rural banks	923.6m	947.5m	(23.9m)	103%
NBFI**	25.1m	54.1m	(29.0m)	215%
Financial coops	172.5m	497.7m	(325.2m)	189%

* (Liquidity deficit); ** Non-bank financial institutions *Source:* Appendix 1, Table 1

A shortage of liquidity has been the problem of most small financial institutions, quite in contrast to commercial banks. BPR, the largest entities among the small financial institutions, with consolidated deposits of Rp 8.89tr and loans outstanding of Rp 9.12tr, had a slight liquidity shortage of Rp 0.23tr and an LDR of 103% as of December 2003. The smaller non-bank financial institutions (NBFI), with drastically lower average loan sizes, comprising 4,482 BKD and 1,428 *Lembaga Dana Kredit Pedesaan* (LDKP), with total deposits of Rp 242bn and total loans outstanding of Rp 521bn, still had a severe liquidity shortage of Rp 279bn and an LDR of 215%. Similarly, the 40,527 financial cooperatives, with total consolidated deposits of Rp 1.66tr and loans outstanding of Rp 4.79tr, had a liquidity gap of Rp 3.13tr and an LDR of 189%. The latter figures conceal major differences between the various types of cooperatives: the private credit unions and the Islamic cooperatives are quite balanced, with LDRs of 109% and 111% respectively; while the government-pampered USP and KSP (*Koperasi Simpan Pinjam and Unit Simpan Pinjam*) have ratios of 314% and 469%, respectively. (Data ~2000, see Appendix 1, Table 1)

Two **major issues** and challenges in microfinance remain that apply to both conventional and Islamic financial institutions in Indonesia:

- How to use the existing massive excess liquidity in the banking sector to extend financial services to those segments of the rural population without access.
- Whether, and how, to extend recognition, depositor protection, regulation and (delegated) supervision to large numbers of small financial institutions.

1.2 Macroeconomic and policy framework

There is a considerable correspondence between today's policy concerns and those at the beginning of the 20th century: an emphasis on demand-oriented financial services, institutional viability, sustainability of the system as a whole, as well as experimentation to expand services to the poor with individual and group technologies.[5] Following the oil price increases of 1973 and 1979, Indonesia invested substantial amounts in development, using directed credit as one of its tools. The decline in oil prices after 1982 initiated an era of liberalization, shifting the prime mover of development from government to market forces. Inflation fell from 20% in 1973/74 to 5.7% in 1985/86: an important prerequisite for financial market liberalization. In microfinance, the policy environment evolved rapidly during the 1980s and 1990s, with the following five main developments:

a) Full interest rate deregulation and elimination of credit ceilings in 1983 (preceded by the oil crisis of 1982), which gave birth to the reform of the BRI unit system in 1984.
b) Institutional liberalization in 1988 (preceded by the oil crisis of 1986), which led to the rise of BPR as part of the formal financial sector.
c) The phasing out of 32 of the 36 subsidized credit programs in 1990.
d) A new banking law in 1992, acknowledging two types of banks: commercial banks and rural banks.
e) In the period 1997-2002, financial sector crisis management geared to prudential regulation and effective supervision.

These policies proved extremely successful: during the period 1979-96, GDP grew at 7% p.a.; the percentage of the poor similarly fell from 60.0% in 1970 to 11.5% in 1996.[6] The process of steady growth was unexpectedly interrupted by the Asian financial crisis, *krismon*, which revealed (i) the dangers of financial deregulation without effective supervision (meaning: *enforcement* of prudential regulation); and (ii) the risks of excessive short-term external borrowing. At the same time, it revealed the fragility of poverty alleviation, leading the number of poor to double, mostly from the category of the near-poor, to reach around 20% of the population by 1999.[7] Since 2000, there have been clear signs of recovery. From 2001 to 2003, GDP grew at rates between 3.5% and 4.1%, while the inflation rate fell from 12.6% to 5.1%.[8]

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[5] "Interest rates had been set high enough not only to cover costs but to increase the institutions' equity base through retained earnings (BKD). Subsidies were limited to initial start-up support after which the institutions had to become viable. Maturities and repayment schedules of the loan products were designed according to the needs of the customers. Unsecured, 'character-based' lending was common […] Innovative techniques like group-lending and joint liability were developed and tested (and given up again). Strict loan enforcement was common […]" (Steinwand 2001: 103).

[6] World Bank, Indonesia Country Assistance Note, 29 March 1999.

[7] Official figures for 1999 vary from 18.2% (Susenas, Central Bureau of Statistics) to 27.1% (Smeru).

[8] In addition, interest rates declined: average bank lending rates for working capital credit fell from 19.2% to 15.1%, one-month fixed deposit rates from 16.1% to 6.6%, and one-month Treasury bills (SBI) from 17.6% to 8.3%.

2. Principles and products of Islamic finance

The principles of Islamic finance are laid down in Islamic law, the sharia, شريعة. Islamic finance, comprising financial transactions in banks and non-bank financial institutions formal and non-formal financial institutions, is based on the concept of a social order of brotherhood and solidarity. Participants in banking transactions are considered business partners who jointly bear the risks and profits. Islamic financial instruments and products are equity-oriented and are based on various forms of profit and loss sharing. As Islamic banks and their clients are partners, both sides of the financial intermediation are based on sharing risks and gains: the transfer of funds from clients to the bank (depositing) is based on revenue-sharing and is usually calculated ex post on a monthly basis[9]; the transfer of funds from the bank to the clients is based on profit-sharing (lending, financing), either at a mutually agreed-upon ratio as in the case of *Mudarabah*, or at a mutually agreed-upon fixed rate. Such ratios and rates vary between institutions and may also vary between contracts within the same institution, contingent upon perceived business prospects and risks. Islamic banking finances only real transactions with underlying assets; speculative investments such as margin trading and derivatives transactions are excluded. Lending, or financing, is backed by collateral; collateral-free lending would normally be considered as containing a speculative element, or moral hazard. Similarly, to avoid speculation and moral hazard, normally only investors with several years of successful business experience are financed. The paying or taking of interest (*Riba*) is prohibited. The same principle of partnership is applied to Islamic insurance. It is based on a collective sharing of risk by a group of individuals whose payments are akin to premiums invested by the Islamic banking institution in a *Mudarabah* arrangement for the benefit of the group.

The fundamental principle of solidarity at the societal level finds its expression in a special category of financial products without remuneration (*Qard*). Investors without adequate business experience who are considered high-risk may receive a moderate amount of financing on *Qard Hasan* terms, free of any profit-sharing margin, but usually to be repaid by installments and backed by collateral. Similarly (but rarely in Indonesia), depositors may save in an Islamic financial institution without receiving a remuneration, usually with the expectation that the funds will be used for social or religious purposes. In inflationary economies, *Qard* deposits and financing pose unresolved problems. A typology of Islamic financial products is presented below.

[9] In one sense, depositors are treated like shareholders; in another sense, they are treated better than shareholders, as they share in the revenue and not the profit or loss.

Table 3.1: Typology of Islamic financial products

1. Financing products

Profit-sharing financing products	
Musharakah Musyarakah مشاركة	Equity participation, investment and management from all partners; profits are shared according to a pre-agreed ratio, losses according to equity contributions.
Mudarabah مضاربة	A profit-sharing partnership to which one contributes the capital and the other the entrepreneurship; or the bank provides the capital and the customer manages the project. Profit is shared according to a pre-agreed ratio.
Qard Hasan Qard al-Hasanah حسن	Charitable loans free of interest and profit-sharing margins, repayment by installments. A modest service charge is permissible.
Wakalah وكالة	An authorization to the bank to conduct business on the customer's behalf.
Hawalah حوالة	An agreement by the bank to undertake some of the liabilities of the customer, for which the bank receives a fee. When the liabilities mature, the customer pays the bank back.
Advance purchase financing products	
Murabahah مرابحة	A sales contract between a bank and its customers, mostly for trade financing. The bank purchases goods ordered by the customer; the customer pays the original price plus a profit margin agreed upon by the two parties. Repayment by installments within a specified period.
Istithna' إستثناء	A sales contract between bank and customer where the customer specifies goods to be made or shipped, which the bank then sells to the customer according to a pre-agreed arrangement. Prices and installment schedules are mutually agreed upon in advance.
Mu'ajjal Bai al Salam بيع مؤجل	Purchase with deferred delivery: A sales contract where the price is paid in advance by the bank and the goods are delivered later by the customer to a designee.
Ajaar Ijarah Ijarah Mutahia Bittamlik آجا	**Lease and hire purchase:** A contract under which the bank leases equipment to a customer for a rental fee; at the end of the lease period, the customer will buy the equipment at an agreed price minus the rental fees already paid.

2. Deposit products

Wadi'ah وديعة	Sight deposits, including current accounts (*Giro Wadi'ah*).
Mudarabah مضاربة	Deposit products based on revenue-sharing between depositor and bank, including savings products that can be withdrawn at any time, and time deposit products.
Qard al-Hasanah حسن	Unremunerated deposit products, usually for charitable purposes (*widespread in Iran, but not found in Indonesia*).

3. Insurance products

Tadamun, Takaful تضلمن - تكافل	Islamic insurance with joint risk-sharing.

3. Evolution and structure of Islamic finance in Indonesia

3.1 Typology of Islamic financial institutions in Indonesia

Islamic finance is defined as a financial system based on Islamic law, شريعة , variously transcribed as shar'iah, sharia or Syariah. In Indonesia, Islamic finance is referred to as sharia finance when addressed to a wider audience (as in central bank publications), or *Syariah* finance when addressed to a predominantly Islamic audience. In this study, both terms are used. Islamic finance in Indonesia comprises two types of institutions:

- banking institutions, which fall under the banking law, and
- financial cooperatives.

There are three types of Islamic banking institutions, of which the first two fall into the legal category of commercial banks:

- Full-fledged Islamic commercial banks: Bank Umum Syariah(BUS)
- Islamic banking units of commercial banks: Unit Usaha Syariah (UUS)
- Islamic rural banks: Bank Perkreditan Rakyat Syariah (BPRS)

The Indonesian banking law recognizes two types of banking institutions: commercial banks and rural banks (BPR), with widely differing minimal capital requirements. The Islamic commercial banks and commercial banking units are a subcategory of the commercial banks, while the Islamic rural banks (BPRS) are a subcategory of the rural banks (BPR). The subcategories are included in the respective banking statistics by the central bank.

The Islamic financial cooperatives in Indonesia are not part of the formal financial sector. They may or may not be registered with the Ministry of Cooperatives; accordingly, they may be placed into either the semiformal or the informal financial sector. As they are not formally regulated, the distinction is of limited relevance. Initiated by a group of Muslim intellectuals and promoted by PINBUK, they are generally generically referred to as BMT. Their development has been favored by the Muslim organizations Nadhatul Ulama and Muhamadiyah, but were not established by them. Since 1999, when Muhamadiyah began to provide guidance and supervision through Pusat Pengembangan Ekonomi Muhammadiyah (PPEM), one of its departments, these financial cooperatives have been grouped into two categories, BMT and *Baitul Tamwil Muhamadiyah* (BTM):

- BMT *Baitul Maal wat Tamwil*, comprising about 95% of Islamic cooperatives, affiliated to Nadhatul Ulama (NU), which is, with almost 40 million members, the largest Islamic mass organization in Indonesia. However, NU does not play an active role in guiding and supervising BMT, which are under the guidance of PINBUK. It should be noted that statistics on BMT usually include the BTM (unless otherwise stated).

- BTM *Baitul Tamwil Muhamadiyah*, comprising about 5% of Islamic cooperatives, guided since 1999 by Muhamadiyah, which is the second-largest Islamic mass organization in Indonesia with some 25 million members. BTM are informally supervised by PPEM.

BMT reportedly have a mixed commercial and social orientation, while BTM are more definitely commercially oriented.

3.2 Institutional and regulatory framework: Mainstreaming Islamic banking

Bank Indonesia (2002:16) has provided the following vision and mission for the development of sharia banking in Indonesia:

"A sound sharia banking system that is competitive, efficient and compliant with prudential practices, and capable of supporting real economic sector through the implementation of share based financing and trades with real underlying transactions in the spirit of brotherhood and good deeds to promote well-being for all society."

The strategic objectives of sharia banking development, according to Bank Indonesia (2002:5), include:

- a high level of competitiveness while complying with sharia principles;
- a significant role in sustaining the national economy and public welfare;
- global competitiveness through compliance with international operational standards.

As of 1998 (Act No. 10), Bank Indonesia officially recognized, as part of the new Banking Act, the existence of a **dual banking system, conventional and sharia-based**. The mainstreaming of Islamic banking was backed by Act No. 23 of 1999 concerning Bank Indonesia, which authorizes the central bank to conduct its task also according to sharia principles (see sub-section 2.1). Beyond this, the law does not specify any substantively different provisions for Islamic banking. In 1999 Bank Indonesia established a team for sharia banking, which was then converted in 2001 into a bureau and in 2003 upgraded into a directorate, with the objective of monitoring the new segment of the banking sector. At national and institutional levels, Islamic finance is supervised by sharia supervisory boards (SSB). On the whole, Bank Indonesia (2002:11) states that there is a "lack of efficient institutional structure supporting efficient sharia banking operations" and suggests the need to develop the following:

- A *sharia auditor* to ensure the compliance of sharia banks with sharia principles
- A *Communication Board* (FKPPS) to enable effective coordination of efforts to improve public awareness and education with regard to sharia banking
- An *Institution for Sharia Financing Insurance* to provide sharia banks with financial protection against fraudulent practices by recommended customers

- A *Sharia Finance Information Center*, which would act as a link between the real finance and sharia finance sectors
- A *Special Purpose Company* to facilitate asset securitization for Islamic banks.

The **major stakeholders,** according to Bank Indonesia (2002:5), are:

- Sharia commercial banks, sharia banking units and sharia rural banks
- Bank Indonesia as the banking regulatory and supervisory authority
- The National Sharia Council (DSN)
- The *Muamalat* arbitrage body (BAMUI)
- Other sharia financial institutions: Takaful (sharia insurance), cooperatives, BAZIS, and sharia security companies
- Other regulatory bodies: the Ministry of Finance and the capital market regulatory body (BAPEPAM)
- Universities and educational institutions with sharia finance and economics programs
- Sharia-related organizations and companies such as the Sharia Economic Society (MES), the Association of National Sharia Banks, the Jakarta Stock Exchange
- The general public.

3.3 Origins and development of Islamic commercial and rural banks

Beginnings: In 1990, a meeting of *ulama*, or Islamic scholars, was convened in Indonesia on the prohibition of *Riba* as demanded by the Koran. In 1991 a technical team was formed, and steps were taken to establish Islamic commercial and rural banks. The first four BPRS were licensed and almost immediately opened during the second half of 1991: three in the Bandung area, and one in Aceh. Five more were licensed, all but one of which opened in 1992. Approval for the establishment of the first Islamic commercial bank, Bank Muammalat Indonesia (BMI), was granted in 1991, and the bank obtained its license in May 1992. Towards the end of 1992, ASBISINDO (Asosiasi Bank Islam Indonesia) was established, originally as an association of BPRS. In 1998 ASBISINDO was renamed Asosiasi Bank Syariah Indonesia, now with both rural and commercial banks as members, but keeping the original acronym.

Growth of Islamic commercial banking: A new phase of *Islamic commercial banking development* was initiated in 1999 when a second commercial sharia bank was established, Bank Syariah Mandiri.[10] In the same year, the first sharia unit of a commercial bank was established. By December 2003, the number of Islamic commercial banks still stood at two, but the number of commercial banking units had grown to eight, comprising a total of 255 banking offices (see Table 3.2). The most remarkable feature has been the doubling of the number of bank offices of the Islamic commercial banks and banking units between December 2002 and December 2003 from 127 to 255. This was paralleled by the near-doubling of banking assets from Rp 4.02tr to Rp 7.86tr – an increase of 96% in nominal and 91% in real terms (see Table 3.3).

[10] Bank Mandiri, which 100% owns Bank Syariah Mandiri, acquired a small conventional commercial bank, Bank Susila Bakti, and converted it into a separate Islamic bank.

Table 3.2: The evolution of Islamic commercial banks

No.	Phase	Period	Number of banks and Islamic units
1	Establishment, no institutional growth	1992-1998	1
2	Gradual expansion	1999-2003	10

Stagnating Islamic rural banks: The growth pattern of Islamic rural banks has been quite different. After an initial period of gradual growth until 1996, when they reached a total of 71, their number almost stagnated, reaching 78 by 1998 and a mere 84 by 2003. During the four-year period, 1999-2003, the number of Islamic rural banks grew by a meager 8% from 78 to 84, while the number of Islamic commercial banking offices grew more than fivefold from 40 to 255.[11]

Table 3.3: The evolution of Islamic rural banks (BPRS)

No.	Phase	Period	Number of Islamic rural banks
1	Gradual expansion	1991-1996	71
2	Slowdown of expansion	1997-1998	78
3	Stagnation	1999-2003	84

Similarly, during 2003, when Islamic commercial banks doubled their assets, the number of BPRS grew by only one unit, and their total assets by a mere 16% (11% in real terms).[12] (See Table 3.4.)

Table 3.4: Growth of Islamic banking, 1991-2003

Type of Islamic bank	1991	1992	1999	2000	2001	2002	2003
Commercial banks	0	1	2	2	2	2	2
Commercial banking units	0	0	1	3	3	6	8
No. of commercial banking offices	0	1	40	62	96	127	255
Rural banks	4	9	78	78	81	83	84
Total number of institutions	**4**	**10**	**81**	**83**	**86**	**91**	**94**
Total number of offices (A)	**4**	**10**	**118**	**140**	**177**	**210**	**349**
Total number of offices (B) incl. rural bank branches							**517**

[11] There are no statistics on the number of branches of rural banks. In our sample study of five BPRS, the average number of branches was 2.0. If we generalize this, we arrive at a total number of 168 BPRS branches and a total number of Islamic commercial and rural bank offices of 517.

[12] As of May 2004, one new sharia commercial bank (via the conversion of Bank Tugu into Bank Mega Syariah), five sharia district development bank units (BPD), four private commercial bank units and fifteen BPRS were in the process of being established. This will bring the total to 20 commercial banks and banking units and 99 BPRS.

Lack of popular demand: There is no indication that the establishment of Islamic banks in Indonesia was preceded by broad popular demand for sharia-based Islamic financial services. Indeed, at present this situation appears to have changed little. According to surveys carried out in several provinces with an average Muslim population of 97%, only 11% were found to understand the products or the benefits of sharia banking. Bank Indonesia (2002:10) thus concluded that

> There is still a gap between needs and knowledge of sharia financial products and services. The gap could delay the success [in mobilizing] potential public fund[s] to investment because of [the] low switching rate from potential demand to real demand. Furthermore, the gap will also make marketing and selling effort[s] for sharia banking products and services more difficult.

3.4 Conventional and Islamic commercial banking: A comparison

There are 138 commercial banks in Indonesia, of which two are Islamic: Bank Muamalat Indonesia and Bank Syariah Mandiri. In addition, there are eight Islamic banking units: Bank IFI, Bank Negara Indonesia, Bank Jabar, Bank Rakyat Indonesia, Bank Danamon, Bank Bukopin, Bank Internasional Indonesia and one foreign bank, HSBC. Of particular relevance is the entry of the latter as a foreign non-Islamic bank into Islamic banking operations, indicating that the prospects for Islamic banking in Indonesia appear attractive to foreign investors.

In terms of numbers, the two Islamic commercial banks represent 1.4% of all commercial banks. If we treat the eight commercial banking units like separate commercial banks and add them to the total number, then the Islamic commercial banks and commercial banking units combined account for 6.8% of the total number of 146 banks and banking units. Islamic bank offices account for 3.3% of all commercial banking offices if the BRI units are excluded, and for 2.2% if they are included. In terms of total banking assets and financial activities, Islamic banks and banking units represent a mere 0.74% of total banking assets, 0.64% of total deposits, and 1.16% of total loans outstanding. The share in total assets remains the same with or without rural banks; it also remains the same if we add financial cooperatives.

However, although Islamic commercial banking represents but a small proportion of overall commercial banking in Indonesia, it has recorded phenomenal growth in recent years, quadrupling its share in terms of total assets from 0.17% in December 2000 to 0.74% in December 2003. In similar fashion, deposits have more than quadrupled from 0.15% to 0.64%; and financing almost tripled from 0.40% to 1.16% (see Table 3.3, as well as Appendix 3, Table 1).

Table 3.5: Share of Islamic to national commercial banking activities, 2000-2003 (in %)

Item	2000	2001	2002	2003
Assets	0.17	0.25	0.36	0.74
Deposits	0.15	0.23	0.35	0.64
Loans (*or:* financing)	0.40	0.57	0.80	1.16

Sources: Bank Indonesia 2003:127; 1/2004:13

Most remarkable is the **difference in performance between conventional and Islamic commercial banks.** In relative terms, (i) Islamic banks lend more funds deposited, with an LDR or financing-to-deposits ratio (FDR) of 97%, compared to 54% of the total commercial banking sector; and (ii) their gross non-performing loans (NPL) ratio is persistently lower, and the improvement of their performance is faster than that of conventional banks after the financial crisis. NPLs amount to 2.3% of financing outstanding, which is far below the 8.2% of the total commercial banking sector.[13] NPL ratios fell as follows (see Appendix 3 Table 2):

- Conventional banks: from 26.8% in 2000 to 14.1% in 2001, and 8.2% in 2003;
- Islamic banks: from 13.0% in 2000 to 4.0% in 2001, and 2.3% in 2003.

However, despite the Islamic banks' better performance in terms of portfolio quality, their return on average assets (ROAA) is, at 0.65%, less than a third of the ROAA of the total commercial banking sector at 2.12%. This difference can be partially attributed to the increase in the number of Islamic banking units, which have only recently started to lend, with a major portion of their loans not yet matured. This explains their higher CARs as indicated below, as well as the overall decline in the profitability of Islamic commercial banks and banking units from 1.2% in 2001 to 0.6% in (November) 2003 (see Appendix 3, Table 3).[14]

3.5 Development of Islamic financial cooperatives

The development of Islamic banking has been paralleled by that of Islamic financial cooperatives, or BMT. The first Islamic cooperative, Ridho Gusti, was established in 1990 in Bandung. After 1995, when PINBUK started promoting Islamic cooperatives under the new label of BMT, they increased in number over several stages: an initial period of moderate growth up to 1995; the promotion of rapid growth by PINBUK starting in 1995, with large jumps in numbers during the crisis years of 1997 and 1998; a slowing down of growth in 2000; followed by stagnation and then a slight decline, as Table 3.7 below shows.[15]

[13] The NPL ratio of 2.3% comprises non-performing loans that are 1.04% sub-standard, 0.29% doubtful and 1.0% losses.

[14] For further information on deposits and loans by Islamic commercial banks, see Appendix 3, Tables 4-5.

[15] These figures should be interpreted with the caution, given that available data are of poor quality.

Table 3.6: The evolution of Islamic cooperatives

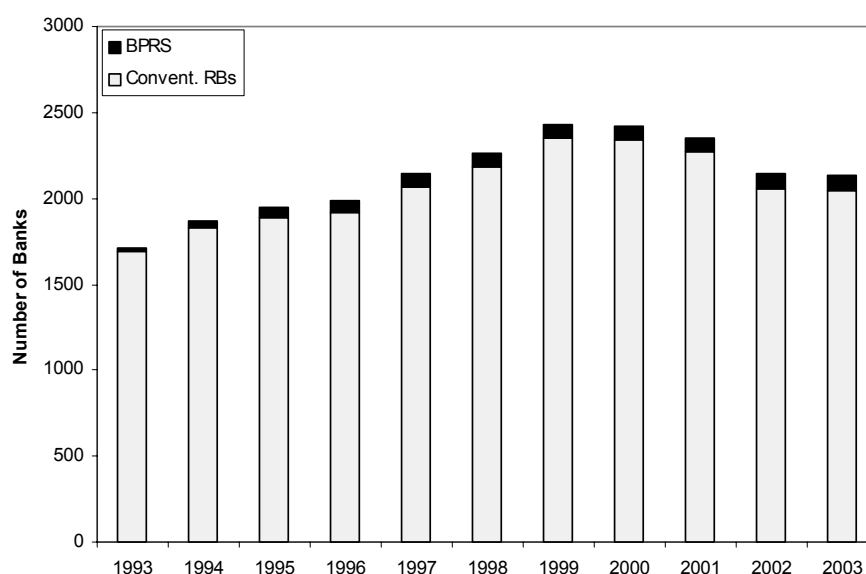
No.	Phase	Period	Number of BMT
1	Initial growth	1990-1995	300
2	Rapid growth promoted by PINBUK	1996 1997 1998 (June)	700 1,501 2,470
3	Slowing down of growth	2000	2,938
4	Stagnation and decline[16]	2001 2003	3,037 2,856

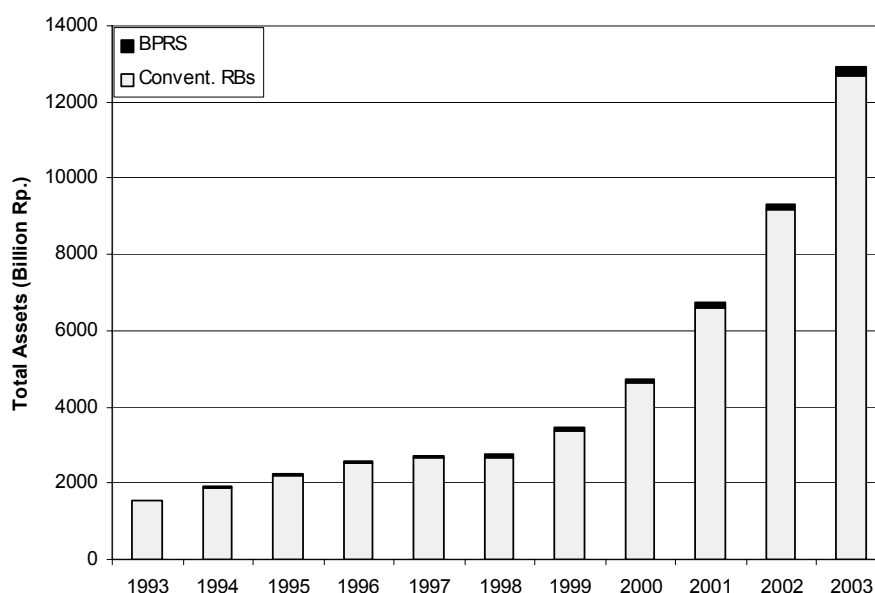
[16] Data for 2003 are based on oral information provided by PINBUK.

4. Islamic rural banks (BPRS)

4.1 Conventional and Islamic rural banks (BPR and BPRS): A comparison

Conventional and Islamic rural banks have evolved over a similar time span, in a predominantly Islamic country: conventional rural banks since 1989, Islamic rural banks since 1991. At what pace did this take place in a predominantly Islamic country, and with what result? During the 15-year period lasting from 1989 to 2003, the total BPR sector grew to 2,134 institutions[17], comprising 2,050 conventional BPR and 84 BPRS. The average growth rate of conventional BPR during this 15-year period was 137 institutions per year – compared to only 6.5 BPRS p.a. during the slightly shorter 13-year period. *Conventional rural banks have thus grown more than 20 times faster than Islamic rural banks on a yearly basis.*

Graph 4.1: Number of conventional and Islamic rural banks, 1993-2003

[17] 62% of them newly established, and 38% converted from existing non-banking institutions.

Graph 4.2: Total assets of conventional and Islamic rural banks, 1993-2003

During a six-year period between 1991 and 1996, BPRS grew at an overall average of 12 per year. This level slowed when the Asian financial crisis hit Indonesia in 1997 and 1998 to less than four per year. During the following five years, 1999-2003, their net growth more or less stagnated, averaging one per year: seven were newly established, and two were closed at the beginning of 2004. Their total number was 84 in December 2003, declining to 82 in February 2004. Detailed data are presented in Appendix 2.

With Rp 191.75bn in total assets (December 2003), *Islamic rural banks account for 1.5% of the regulated BPR sector.* Total assets per BPRS are on average Rp 2.28bn or US$ 270,100 per BPRS, compared to Rp 6.05bn or US$ 715,300 per BPR. **With just 38% of the assets of an average BPR, BPRS are thus much smaller.**

BPRS account for 1.5% of loans (financing) outstanding, but only 1.2% of deposits of the total BPR sector. Historically, the share of BPRS in total assets of the BPR sector initially grew from 0.75% in 1993 to reach a high of 2.93% in 1998, paralleled by increases in the share of loans outstanding from 0.62% in 1993 to a high of 2.88% in 1998, and in the share of deposits from 0.62% in 1993 to a high of 2.42% in 1998. The decline in the share of BPRS since 1999 is due to wide discrepancies in the growth rates of BPR and BPRS in recent years, as shown in Table 4.1 below. During the three-year period December 2000 to December 2003, the ***total assets of the BPR sector grew (nominally) by 173% and the assets of the BPRS by 70%***, despite the fact that the total number of BPR declined by 12% from 2,419 to 2,123, while the number of BPRS increased by 5% from 80 to 84 during that period.

Table 4.1: Growth rates of BPR and BPRS over three years, Dec. 2000-2003 (in %)

	BPR sector	BPRS
Total assets	173	70
Deposits	189	76
Loans outstanding	154	68

In terms of total numbers, BPRS account for about 4% of the BPR sector, and 1.5% in terms of total assets. The average Islamic BPR is thus **less than half the size of the average conventional BPR**. As shortage of capital is one of the main reasons for the failure of many unregulated small financial institutions to transform into regulated BPR, and as most BPRS are so much smaller than conventional BPR, we may hypothesize that capital shortage is one of the causes of the slow growth of the Islamic rural banking sector.

Table 4.2: Conventional and Islamic rural banks (BPR and BPRS), December 2003 (amounts in billion Rp)

	Total BPR sector	Conventional BPR	BPRS	
			Absolute	% of total
No. of banks	2,134	2,050	84	3.9
Total assets	12,905.7	12,714	191.75	1.5
Total deposits	8,890	8,780	110.0	1.2
Total loans outstanding	9,180	9,041	138.6	1.5

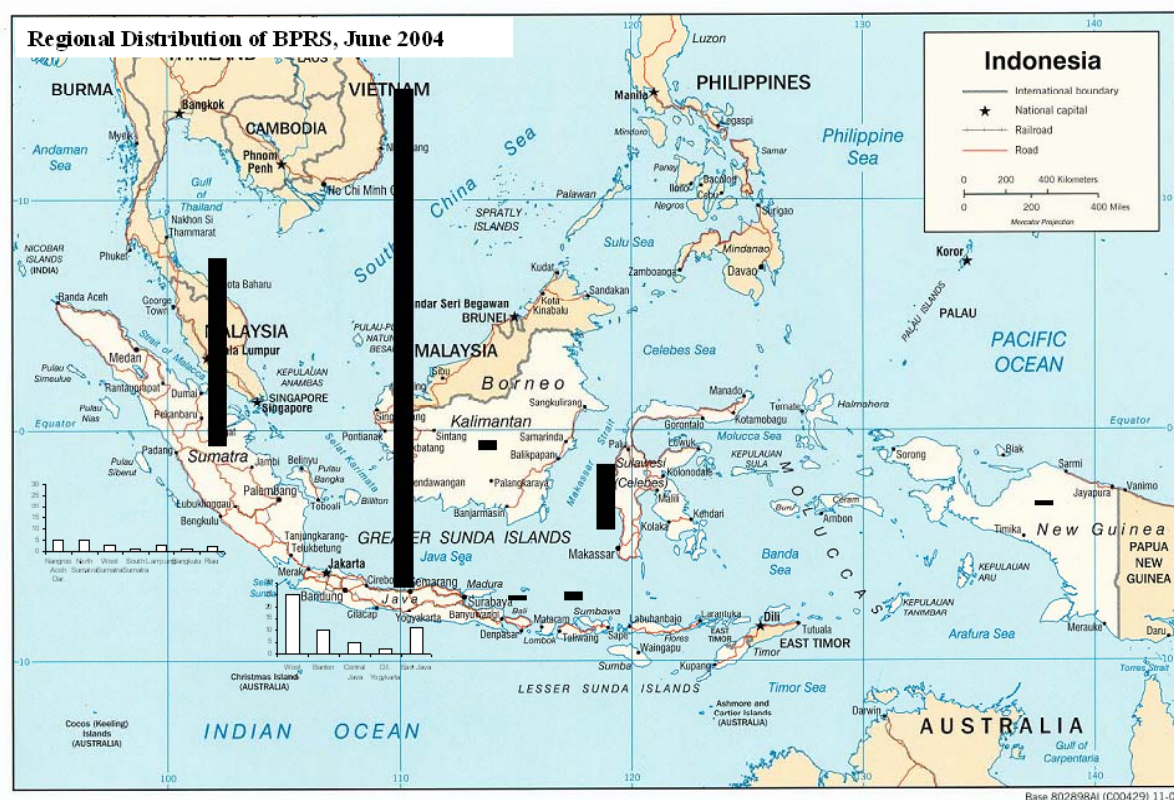
In sum, Islamic rural banks account for 2.4% of the total Islamic commercial and rural banking sector, 1.5% of the rural banking sector, and just 0.018% of the total banking sector. Their growth has lagged far behind that of conventional rural banks:

- The number of BPRS grew annually at a rate of 6.5 banks, compared with conventional BPR at a rate of 137.
- Average assets of BPRS amount to only 38% of the assets of conventional BPR.
- During the period 2001-2003, total assets of the BPRS grew (nominally) by 70%, compared to a growth rate of 173% for the total BPR sector.

4.2 Regional distribution

Of the 90 BPRS licensed between 1991 and June 2004, 86 are still active. Of the four BPRS, located in western Java, two have been closed, and two are in the process of being closed. The majority of BPRS, 62%, are located on Java (where the majority of the population of Indonesia lives), mostly in western Java (41%), which comprises the provinces of West Java and Banten. 20 BPRS, or 23%, are spread over seven provinces

on Sumatra, with the largest number, namely five each, in Aceh and North Sumatra. The other ones are spread very thinly over the remaining archipelago (see Appendix 4, Table 1). The geographical distribution by major island and province is shown in the map below. (For a complete list of all BPRS and their locations, see Annex 1.)

Map 1:

4.3 Mission, ownership and governance

The mission of Islamic rural banks in Indonesia is to help the enterprising poor, particularly small traders and micro-entrepreneurs. In the four sample BPRS, the average percentage of clients below the official poverty line was estimated at 6%. The explicit pro-poor emphasis of Islamic MFIs is in contrast to conventional BPR, which are oriented to profit-making. Two problems have resulted from the way the BPRS have defined their mission: on the demand side, many customers have a (mistaken) concept of sharia banking, namely that there are low or no interest rates or profit margins. On the supply side, BPRS focus on the micro sector instead of starting with more profitable market segments such as salary earners and small entrepreneurs. It is this difference in mission which has contributed to the slow growth of BPRS. While both are (mostly) established by wealthy local people, the owners of BPR are commercially oriented towards increasing their wealth, while the owners of BPRS have a social mission, combined with the intention to at least cover their costs.

Ownership: Most BPRS are privately owned, usually by one majority shareholder and several minority shareholders. In the five sample BPRS, there are between three and 118 owners, mostly private individuals (see Appendix 4, Table 2). In some cases, Islamic foundations, companies and local government are shareholders. Some Islamic cooperatives, BMT, have started to establish a BPRS, but due to a lack of capital are not shareholders. Most owners are absentee owners, living in Jakarta or one of the provincial capitals. If there are many shareholders, their involvement in decision-making is small if not absent. In contrast, many owners of conventional BPR also act as general managers or president-directors.

Board of directors: Every BPRS has three boards: a sharia board which watches over compliance with Islamic principles, a management board and a supervisory board. Members of the sharia board usually come from religious organizations like the local *Majlis Ulama*, from mass organizations and Islamic universities. The supervisory board of commissioners (*komisaris*) comprises representatives of majority shareholders and financial experts. There are usually three members on the sharia board and three on the supervisory board. It is rare that any member has a regular full-time or part-time position; most act perhaps one day a month or upon request. The management board usually comprises a director and a deputy director, who are both full-time employees. In the five sample BPRS, the boards of directors have between seven and ten members (Table 2).

Management: Upon the insistence of Bank Indonesia as the regulator, management is usually comprised of one or two directors with banking experience. As Islamic banking is a relatively recent innovation and given an overall shortage of trained bankers, very few BPRS managers have any experience in sharia banking. Most are retirees from conventional banking, who have received only some training in Islamic banking principles. This has resulted in a selection of older people, frequently from state banks, who perhaps lack the drive and innovativeness that one might expect from younger people eager to experiment with new ideas in Islamic banking. Management is largely autonomous, sometimes indeed too much so, particularly in the case of absentee owners combined with management by retired state bankers experienced in enforcing bureaucratic rules rather than exploring new products and customer segments. No evidence was found of any controversial issues repeatedly arising between management, board and shareholders. Decision-making is by consensus (*musyawarah*). Lack of management skill and dynamics are considered the only major problems.

Control and supervision: *Internal control* is by absentee commissioners whose activities are limited to receiving monthly reports and monthly or quarterly visits: either the commissioners visit the bank; or the bank visits the commissioners – sometimes in far-away places. Their role is generally considered not very effective - hence the considerable autonomy of management. *External auditing* by a public accountant is compulsory if assets exceed Rp 10bn, but most lack dynamic growth and remain below that limit. ASBISINDO, the business association of Islamic banks, recommends voluntary external auditing, which is problematic as historical experience has shown. *Supervision* of BPRS as part of the banking system is compulsory and carried out by Bank Indonesia on an

annual basis. *Accounting and reporting standards,* including the computation of standard performance ratios, are regulated and enforced by Bank Indonesia.

4.4 Delivery system, market and outreach

There are no statistics on the **number of branches** of BPRS. In its official reports, Bank Indonesia purely lists the number of delivery units of commercial banks. Of the five sample BPRS, only one is a unit bank; the other four were one and four branches*. The average number of delivery units (including the head office) is three. The sample BPRS have between 11 and 38 **staff members**, averaging 21.4 per BPRS and 4.3 per delivery unit. Half the staff members (49%) are loan officers, usually equipped with motorbikes. Their service radius is between 20 and 50 km, averaging 38 km (see Appendix 4, Table 3)

Incentive scheme: Most BPRS have a system performance incentive scheme based on an annual bonus which is related to the bank's profit, rather than to the performance of individual staff members. There is an ongoing discussion on how to adjust staff remuneration to the profit-sharing principle of Islamic banking, with a basic salary to cover transportation and an advance, plus a sharing of the profit between owners and staff according to an agreed-upon ratio. BPRS Mentari in Garut is experimenting along these lines.

Market segment: The BPRS market segment covers the enterprising poor with existing enterprises, predominantly small traders. BPRS are open to all, irrespective of their religion.
Outside religious organizations, there seems to be no public debate over interest rates or the principles of conventional vs. Islamic banking. It appears that Islamic banking is a matter of access and effectiveness rather than religious conviction. Ultimately, Islamic banking in Indonesia will have to prove its worth in terms of outreach and quality of service.

- There does not seem to be any public awareness of Islamic economics and banking, nor widespread demand for such services from the target group.

Depositor and borrower outreach: Figures on outreach are highly problematic as banks normally report amounts of deposits and loans outstanding, but rarely if ever the number of depositors and borrowers. BPR as well as the BRI units provide data on the number of deposit accounts and loan accounts, which must not be confused with the number of clients, as one client might hold several accounts. This is less likely with regard to loan accounts, which are thus close to the number of borrowers.

There are no overall statistics on the number of clients of BPRS. According to official statistics, the total depositor outreach of the BRP sector as of 2003 is 5.5 million. The average number of depositors per BPR is 2,594[18] (see Appendix 1, Table 1). As BPRS

[18] Compared to an average depositor outreach of 7,374 per BRI unit.

have only 38% of the asset size of BPR, a reasonable estimate would be an average of less than 1,000 depositors.[19] The total depositor outreach of the 84 BPRS can therefore be estimated at 83,000.[20]

The total borrower outreach of the BPR sector as of 2003 is 2.0 million, with an average of 934 per BPR.[21] If we assume that, as in the case of assets, the average number of borrowers of an BPRS is 38% of that of a BPR, we arrive at a figure of 355 and a total borrower outreach of all 84 BPRS of around 30,000.[22]

Composition of clients: There are no overall statistics. In our five sample BPRS, most clients (on average 79% per BPRS) are small traders and micro-entrepreneurs; of the remainder, 17% are wage and salary earners, and 3% are farmers. The percentage of women clients varies from 0 to 45%, with an average of 28%. About 5% are estimated to be below the official poverty line (see Appendix 4, Table 5).

Financial products for the poor and non-poor: Under sharia banking, there are two models of client selection: (i) clients with existing businesses and successful operations for at least two years, and (ii) new entrepreneurs without previous business experience. The vast majority of clients fall into the first category, with an existing business and a good track record; they can be financed through such financial products as *Murabahah*, *Musyarakah* and *Mudarabah*, which involve some form of profit-sharing. New clients without a track record are considered very risky and represent a small minority of the total clients funded; they can be financed through *Qard Hasan*, soft loans without any charge or profit-sharing. It is argued that not everyone is a born (micro-) entrepreneur; many of the poor lack the qualifications to become entrepreneurs and would be better off working in larger enterprises, which may in turn be financed by financial institutions. Consumer loans and loans for speculative investments, which could be ruinous to the borrower, are excluded from the range of permissible purposes of financing.

4.5 Total assets and sources of funds

Total assets of the BPRS, according to the consolidated balance sheet of all BPRS as of December 2003 compiled by Bank Indonesia, amount to Rp 191.75bn, or an average of Rp 2.28bn (US$ 270,000) per BPRS. BPRS are, at 38% the size of an average BPR and 37% the size of an average conventional BPR, thus much smaller than conventional BPR. Total assets in our five sample BPRS range from Rp 1.40bn to Rp 12.6bn; the average is

[19] In four of our five sample BPRS, the average number of clients was nearly 4,000, equal to the number of savings accounts. This unexpectedly large number of clients is related to the fact that the sample BPRS are more than three times the size of the average BPRS in terms of assets.

[20] Basis of calculation: 38% of the average BPR.

[21] Compared to an average borrower outreach of 766 per BRI unit.

[22] Only one of the BPRS visited, BPRS Fisabilillah, was able to provide an exact number of loan accounts, namely 163; the number of active borrowers was given as 157. Two BPRS estimated the number of borrowers at 800; BPRS Wakalumi, by far the largest in terms of assets, stated a total of 2,000 borrowers. The overall average is 941, which reflects the unusually large size of the selected BPRS (see Appendix 4, Table 4).

Rp 7.10bn, which is more than three times the size of the average BPRS, and 17% above the size of the average BPR (see Appendix 4, Table 6).

The main source of funds of BPRS, according to Bank Indonesia's consolidated balance sheet, are deposits by clients amounting to Rp 110.0bn, which is 57.4% of total assets. Other main sources of funds are equity including reserves and profits of the current year (22.9%), bank deposits (11.5%), and borrowing (3.8%). Authorized capital amounts to Rp 51.45bn, and paid-in capital to Rp 31.0bn (see Graph 4.2; Appendix 4, Table 7).

4.6 Financial services

Deposits: BPRS are less successful in mobilizing deposits than BPR. The deposit volume of an average BPRS is less than one-third of the sector average (Rp 1.31bn, or US$ 155,000, compared to Rp 4.17bn or US$ 493,000). [23] Among BPRS, deposits amount to 57.4% of total assets, compared to 69.1% among conventional BPR (BPR sector average: 68.9%). BPRS finance 79.4% of their loans outstanding from deposits, BPR 96.8%. In other terms, the LDR of BPRS is 1.26, higher than that of BPR at 1.03 (see Appendix 3, Tables 8-9). We can conclude from this that revenue-sharing is not as attractive to depositors as a fixed interest rate.

Remuneration of depositors is based on the *Mudarabah* principle of partnership-based revenue sharing between depositors and the bank. The ratios vary in the sample BPRS from 30:70 to 50:50. In some banks the revenue-sharing arrangements are negotiable.[24]

Financing (loans): Total financing (loans outstanding) of 84 BPRS as of December 2003 amounted to Rp 1.65bn (US$195,200) per BPRS, compared to Rp. 4.30bn (US$ 509,000) for the whole BPR sector, and RP 4.41bn (US$ 522,000) per conventional BPR. The share of loans outstanding in terms of total assets is virtually the same in BPRS and BPR (as well as conventional BPR) at 72.3% and 71.1%, respectively. Average loans outstanding per BPR amount to Rp 4.3bn, per conventional BPR Rp 4.41bn and per BPRS Rp 1.65bn. The LDR is 126% in BPRS and 103% in both BPR and conventional BPR.

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[23] Total deposits by clients in 84 BPRS amounted to Rp 110.0bn, comprising Rp 58.57bn (53%) in passbook savings, which are voluntary and can be withdrawn at any time, and Rp 51.42bn (47%) in time deposits. In the five sample BPRS, average deposits per bank amounted to Rp 4.0bn or Rp 1.0m per depositor. Several of the sample BPRS offer doorstep collection services.

[24] As an example, BPRS Artha Fisabilillah offers three *Mudharaba* savings products, all voluntary and withdrawable at any time, which differ only by target group; one remuneration-free savings product for religious purposes; and a fixed deposit product with different maturities. Its loan officers offer doorstep collection services, serving about 200 clients a day. In BPRS Harum Hikmahnugraha, the ratios for savings vary from 7% to 11% by client. Returns are calculated on a monthly basis. Annual averages vary from 7% to 12%; the unweighted mean is 8.3%. The revenue-sharing arrangements in the case of time deposits vary between the banks from 40:60 to 70:30 splits. They also vary by maturity, in the case of BPRS Wakalumi from 56:44 to 66:34; the figures for the other four BPRS are estimated averages. Returns on time deposits vary between the five BPRS from 10% to 18% p.a.; variations by maturity in BPRS Wakalumi ranged from 11.35% to 13.37% during 2003. Current accounts are usually remuneration-free. An exception is BPRS Harum Hikmahnugraha, which pays a voluntary bonus. Some banks, such as BPRS Artha Fisabilillah, offer a savings product for religious purposes which carries no remuneration (see Appendix 4, Table 10).

Table 4.3: Financing (loans outstanding) of BPRS and BPR in billion Rp and as a percentage of total assets, December 2003

	BPRS	Conventional BPR	BPR sector
Average loans outstanding per bank in bn Rp	1.65	4.41	4.30
Financing as a % of total assets	72.3	74.5	71.1
FDR, LDR	126	103	103

The main loan product in BPRS is *Murabahah*, i.e. a sales contract between bank and customer with a fixed profit margin for the bank. Flexible profit-sharing, which is cumbersome to calculate, is of minor importance. *Qard al-Hasanah*, a financial product for the very poor for which the bank bears the full risk but receives no remuneration except an administrative fee of around 1%, exists only in theory. It is listed as one of the products in only one of the BPRS visited, and even there had no takers.[25] (See Appendix 4, Table 11 plus text.)

4.7 Economic performance

No data are available on the performance of the BPRS sector as a whole. There are conflicting views on how they compare to conventional BPR. Some argue that the emphasis on financing purely profitable activities and stricter lending terms should result in higher profits, as is in fact the case among Islamic commercial banks. However, others point to the relatively small size of the average BPRS compared to conventional BPR, and their restriction to lower market segments. Our sample BPRS are not representative, as they are much larger than the average BPRS. In four of the five sample BPRS, NPL ratios are between 0 and 11.0%, averaging (unweighted) out at 4.6%. ROAA vary from 2.0% to 5.0%, averaging 3.2%. All of the five sample BPRS reported current year profits (see Appendix 4, Table 12). By comparison, the BRI units, the benchmark MFIs in Indonesia, have an NPL of 2.5% and an ROAA of 5.7%.

Compared to BMI, the first Islamic commercial bank in Indonesia, BPRS pay slightly more on deposits but charge three to four times as much for financing, as BPRS loans are far smaller in size and thus more costly, and BPRS on the whole are less efficient.

[25] BMI, the oldest and largest Islamic commercial bank, also reports *Qard al-Hasanah* loans. However, the amount is insignificant, and these free loans are mainly extended to staff, for example for housing purposes.

Two of the five case studies, the smallest and the largest, are presented below.

Box 1: Two sample BPRS

BPRS Artha Fisabilillah in Cianjur, the smallest of the five sample BPRS, was established in 1994 by nine shareholders. By 1997, as a result of lack of management experience, it was technically bankrupt and had to be restructured. The new management was not however very dynamic and was replaced in 2001 by a retired BRI credit officer. The bank, located next to a local market, has 1,150 savers and 163 borrowers. With a staff of 11, six of them loan officers, it offers doorstep collection services to about 200 clients a day. It also offers deposit services to school children and institutions. Total assets are Rp 1.40bn, deposits Rp 0.62bn and financing outstanding Rp 1.21bn. Its overall performance is not yet satisfactory. The main problem is a lack of funds, due to a shortage of deposits and capital from the owners. The bank is struggling with loan recoveries, but has improved considerably in 2003. Its non-performing finance (NPF) ratios in 2001, 2002 and 2003 were 9.6%, 190.8% and 4.5%, respectively; its loan loss ratios were 8.9%, 18.7% and 6.25%. Yet the bank has been in the black for the past three years, with returns on assets (ROAs) of 2.3%, 1.7% and 2.4% and returns on equity (ROEs) of 7%, 4.3% and 8.75%, respectively. Its main future strategy to improve efficiency is staff upgrading through training (see Appendix 4, Table 13).

BPRS Wakalumi in Ciputat, the largest of the five sample BPRS, was established in 1990 by a foundation (Yayasan Wakalumi) as a conventional BPR and converted for religious reasons into a BPRS in 1994. It has 118 shareholders, among them BMI (19%, down from 49%), the former Minister of Cooperatives (23.5%), a Citybank manager (26%), the founding foundation Yaysan Wakalumi (5.6%) and over a hundred individuals, mostly Muslims working at Citybank. The bank seems to have a successful staff promotion strategy: the president, with an Bachelor’s degree in agriculture, has been with the bank since 1994, learning on the job and promoted up the ranks; while the bank’s director, a woman with a diploma in accounting, has been an employee since 1997 and was promoted to director in 2003. The bank has grown rapidly and now has five branches and a staff of 38, 13 of whom are loan officers. Its 2,000 borrowers are mostly small traders on traditional markets, to whom it sells its financing as Islamic products. It has four financing products, with *Murabahah* the dominant one. Through eight savings products and four term deposit products, it has attracted 5,000 savers. With ROAAs in 2001, 2002 and 2003 of 4.1%, 3.65% and 3.35% and Returns on Average Equity (ROAEs) of 20.3%, 21.05% and 24.1%, respectively, it is highly profitable: a showpiece that could serve as a good apprenticeship training site for other banks, or as an example highlighting the advantages of Islamic banking (see Appendix 4, Table 14).

4.8 Affiliations and support

ASBISINDO was established in 1992 as an association of BPRS; since 2002 it has also covered Islamic commercial banks. There are no other Islamic banking associations in Indonesia. Its objective is to develop Islamic banking in Indonesia by providing human resource development and technical assistance, by ensuring operational standardization and by developing financial products, by facilitating vertical and horizontal communication among Islamic financial institutions, and by offering advocacy and participation in policy dialogue. ASBISINDO's members comprise the two Islamic commercial banks, seven out of the nine Syaria units of commercial banks, and 82 BPRS. Its main activity is the training of management and staff of Islamic commercial banks and rural banks. In 2003 ASBISINDO offered five national courses with approximately 100 participants each, plus four to seven courses with 25-30 participants per regional office. ASBISINDO also issues a quarterly Bulletin and is in the process of preparing a directory of Islamic banking institutions.

ASBISINDO has its head office in Jakarta, housed by Bank Indonesia, and ten regional offices. It is run by a board and an executive secretary (Basril). The head office has a total staff of three; the regional offices, which mainly specialize in providing training, have a staff of one or two each. The board has 14 members drawn from Islamic commercial and rural banks, chaired by Wahyu Dwi Agung, who is also an assistant director of BMI and a commissioner of three BPRS. Basic costs are funded from membership fees, Rp 5m per commercial bank or unit and Rp 1.2m per BPRS per year. These training costs are borne by the participants. Through special projects, Bank Indonesia supports workshops and seminars. There are no international donors; ASBISINDO does not receive any technical assistance from any source.
ASBISINDO maintains close relationships with Bank Indonesia, the national Syaria board Majlis Ulama Indonesia/Dewan Syaria Nasional (MUI/DSN), the national legislative council of Indonesia (DPR), and various business associations.

ASBISINDO's future plans are to become a strong association providing a full range of services to all Islamic banking institutions that are its members; and to contribute substantially to their growth and strength. Among its future services are a certified training program for Islamic bankers recognized and approved by Bank Indonesia. In cooperation with the Islamic Banking Directorate of Bank Indonesia, it is also working on a draft Islamic financial institutions law. ASBISINDO needs donor assistance in the preparation of such a training program and of an Islamic banking law.

PNM refinances BPR and BPRS and other conventional and Islamic financial institutions and supports their capacity development (see sub-section 6.8).

Majlis Ulama is an organization of Islamic scholars which maintains relations with many Islamic banking institutions. It is the initiator of Islamic banking in Indonesia and a shareholder of BMI, the first Islamic commercial bank. Its head office is in Jakarta. It also maintains offices in provinces and districts, where it plays both a socio-economic and a political role.

4.9 Public perception of Islamic banking

In 2000, after ten years of Islamic banking development in Indonesia, Bank Indonesia realized that "the Syariah banks in Indonesia are not growing quickly in terms of their networking as well as size of production compared to the conventional banks… (and that) their development is not based on a newly created industry argument which needs protection and special rights." (Bank Indonesia & RCDS 2000: 2) Arguing that the development of Syariah banks not only depends on the legal framework and the moral values applied in the banks' operations, but also on "society's demand for their products and services", it commissioned interview studies in western and central Java to find out whether such a demand exists; or whether the lack of market demand for specifically Islamic financial services might be one of the explanations for their slow growth. The results are presented in Bank Indonesia and RCDS (2000) and Ratnawati et al. (2000) of Diponegoro University in Semarang.

The results of the study in central Java were ultimately inconclusive.[26] It was found that respondents could be classified into three groups: those who wanted to deal with Syariah banks, those did not, and those who were neutral. It was also found that age and education had an influence on attitudes to Syariah banks; and that some regions (Semarang, Pekalongan, Kendal, Surakarta and Yogyakarta) were more receptive to Islamic banking than others. It was recommended to "intensify socialization through interpersonal media, electronic media, as well as printed media." (Bank Indonesia and Research Center on Development Studies (RCDS) 2000: 21-23)

In contrast, the study in West Java arrived at some unequivocal conclusions:

> In general, the performance of syaria banks, at the present time, is far behind compared to its older brother, a conventional bank:
> 1. People prefer a bank system for its better service in general, facilities provided, credibility, and bank status, while on the other hand people tend to avoid syaria banks for their […] limited services and facilities, poor status, and low credibility.
> 2. People who are open to information and have extensive access to it tend to discontinue (as a customer) being a customer of a syaria bank or refuse (not yet as a customer) to adopt such a system. This shows that syaria banks' performance is considered inferior to (that of) the conventional banks. (Ratnawati 2000: 18)

These conclusions concur with our own observations that there is little popular demand for Islamic banking services; and that their choice is more (though not exclusively) a matter of proximity and convenience than religion. They also concur with the anecdotal observations of the ADB (2003) team, which included a number of BMT in their studies of MFIs – and, in one of them, BMT Al-Iman in Pandeglang District in Banten Province, interviewed three (out of 1,066) members, who all stated that convenience was the main reason for their patronage.

[26] The data analysis was based on logistic regression modeling (logit) and its presentation is incomprehensible.

Box 2: Reasons for the patronage of customers of BMT Al-Imam, Pandeglang District

Three clients of the BMT were interviewed: The first was a woman, a primary school teacher, who had come to make a small deposit into her savings account which had reached a balance of Rp. 1.6 million. She is not a member of the BMT as she has not made the initial deposit required of members. The main reasons for her patronage of this BMT was its convenient location to her home and the relaxed environment with seldom, if ever, a need to form a queue and wait in line.

The second client interviewed was a man, a member of the BMT who has two savings accounts. One is a normal current account with a balance of Rp 100,000, and the other is a savings account designed to meet the annual needs of Moslems during the Idul Fitri celebration in December, when he expects to withdraw the full amount which, by that time, will have reached Rp 300,000. This client also cited convenience and flexibility as a reason for becoming a member of the BMT.

The third client interviewed was a man, a well-off farmer who owns 1.2 ha for the purpose of paddy and vegetable production. This man has four savings accounts with the BMT, the combined total of which was Rp 6.38 million. The main reason given for patronage of the BMT was cited as the quick and convenient services provided, including personalized services, whereby on occasion the staff deliver services to his door.

(ADB 2003, Regional Profile Section VII, Banten (Pandeglang District)

5. Islamic cooperatives (BMT, BTM)

5.1 Conventional and Islamic cooperatives: A comparison

Indonesia has a differentiated sector of cooperatives, which has been historically dominated by the heavily subsidized KUD system: *Koperasi Unit Desa*, multi-purpose cooperatives at sub-district level with units at village level. By law all co-operatives had to be integrated into the KUD system. As government intervention in management and resource allocation stifled any spirit of autonomy and self-help, privately organized credit unions and large numbers of self-help groups resisted being incorporated, including the self-help groups under Bank Indonesia's Program Linking Banks and Self-Help Groups (PHBK). Since the downfall of the Suharto regime, the cooperative sector has seen some liberalization, but is still far from self-organization and autonomy. In fact, the very existence of a Ministry of Cooperatives, with unclear and perhaps counterproductive functions, stands in the way. In the framework of the new decentralization law, cooperatives are now being registered autonomously in the districts and provinces, which is likely to make the task of regulation and supervision more difficult. The lack of authority of the Ministry of Cooperatives (MoC) is reflected in the no-reply rate of 73% among KSP/USP reported by the MoC as of 13 April 2004. There is no national organization of financial cooperatives – as an alternative to the MoC – which could take over the apex functions of liquidity exchange, regulation and supervision.

Financial cooperatives are part of the cooperative sector and have similarly suffered from state interference and subsidies. As financial institutions, they should be prudentially regulated and properly supervised by a financial authority, but they are not. The MoC has been unable, and Bank Indonesia and the Ministry of Finance unwilling, to regulate and supervise them. The draft microfinance (LKM) law of 2001 seemed to prepare the way for incorporation into the regulated financial sector, but it has since been put on hold with an uncertain future. An alternative which has evolved in developed countries such as Germany[27] is a delegated system of regulation and supervision in the hands of national and regional associations of financial cooperatives (turned into local cooperative banks), with their apex auditing federations, which are in turn placed under the banking law and under the ultimate authority of a bank supervision agency.

As there is no reliable reporting system, the figures on financial cooperatives given below are only rough approximations; they are incomplete, based on data from different years and frequently carried forward unchanged over several years. While the Ministry of Cooperatives, now reorganized as the Ministry of Cooperatives and Small Enterprises, is in charge of registration, regulation and supervision, it fulfils these functions extremely poorly: there is only limited and selective registration, inadequate regulation and virtually no effective supervision.

[27] The Netherlands initially followed the same evolutionary path, but eventually centralized cooperative banking into a single institution, Rabobank, converting the former independent financial cooperatives and cooperative banks into branches.

The more than 40,000 financial cooperatives constitute 76% of all formal and semiformal MFIs listed in Appendix 1, Table 1. Most are relatively small in outreach, comprising 34.2% of all loan accounts and 23.5% of all deposit accounts. In terms of volume, they account for 18.1% of all MFI loans outstanding and 4.8% of deposits. The picture changes if we leave out the units of the BRI Microbanking Division, the giant on the Indonesian microfinance scene. Without the BRI units, financial cooperatives constitute 82.0% of all MFIs, 37.8% of loan accounts and 64.5% of deposit accounts; in terms of volume, they account for 38.9% of loans outstanding and 23.8% of deposit balances. Compared to BPR as of December 2003, there are 19 times as many financial cooperatives with six times as many borrowers and twice as many depositors, but only half the volume of loans outstanding and less than one-fifth of their deposit volume. (Table 5.1)

Table 5.1: Financial cooperatives as part of the microfinance sector*

	Units	**Deposit accounts in '000**	**Deposit volume in bn Rp**	**Loan accounts in '000**	**Loans outstan-ding in bn Rp**
Total MFIs	53,471	46,969	34,387	32,463	26,474
Rural banks (Dec. 2003)	2,134	5,535	8,868	1,993	8,985
Financial cooperatives	40,527	11,043	1,659	11,093	4,787
Financial cooperatives in % of all MFIs	75.8%	23.5%	4.8%	34.2%	18.1%
Financial cooperatives in % of MFIs excl. BRI units	82.0%	64.5%	23.8%	37.8%	38.9%

* Adapted from Appendix 1, Table 1

The largest number of financial cooperatives are savings and credit units (USP) of the state-run multipurpose cooperatives (KUD), accounting for 87% of all units, 76% of loans outstanding and 70% of deposits. The savings and credit cooperatives (KSP) are part of the same KUD system but are, in contrast to USP, organizationally and financially independent of the KUD. Together, the reported number of USP and KSP as of 2000 is 36,341, which comprises 97% of all listed conventional cooperatives and 90% of all cooperatives in Table 1.

According to statistics from the MoC, the total number of KSP/USP had grown to 40,639 as of December 2003, which includes those credit unions and BMT which decided to register as cooperatives; the data also include cooperatives which are inactive and have failed to report. The MoC has financial information on 36,376 KSP/USP as of December 2003, showing a decrease of 0.4% in number and 8.8% in total assets (see Appendix 5, Table 1). The statistics are broken down by province, but not by Islamic vs. non-Islamic type.

KSP and USP are on principle registered with the MoC and are subject to a regulatory framework, with minimum capital requirements to become a cooperative, a soundness rating system (based on that for banks) and a loan classification system. However, deficiencies include the absence of legal lending limits, requirements for loan-loss provisioning (which is left up to individual cooperatives) and sanctions. There is no effective supervision; and whatever regulation exists is not enforced after registration. Furthermore, there is no deposit protection system, and there are no KSP/USP associations.

The 1,071 credit unions (*Koperasi Kredit*) are privately organized and supervised by INKOPDIT, their national apex, which has rated 90% of them as sound. They are part of the World Council of Credit Unions (WOCCU), an apex trade association for the credit union movement. A small cooperative movement, Swamitra, has been organized by the state cooperative bank, Bukopin.

The Islamic cooperatives (BMT) are a recent development, with rapid growth during the first part of the 1990s. The 2,938 BMT units (as of 2000) constitute 7.2% of all financial cooperatives, 2.8% of deposits and 1.1% of loans outstanding (ADB 2003). The majority of them are registered with PINBUK rather than with the MoC, which has no information on how many are registered as cooperatives. Bank Indonesia estimates the number of registered BMT at 500 out of a total of 3,000.

Table 5.2: Financial cooperatives: conventional and Islamic, 2000*

	Units	Deposit accounts in '000	Deposit volume in bn Rp	Loan accounts in '000	Loans outstan-ding in bn Rp
Conventional cooperatives	**37,589**	**11,043**	**1,613**	**11,020**	**4,736**
Unit Simpan Pinjam (USP)	35,218	10,141	**1,659**	10,141	3,629
Saving & Credit Coops (KSP)	1,123	551	1,157	551	708
Credit unions (CU)	1,071	296	151	296	272
Swamitra/BUKOPIN	177	55	249	32	127
Islamic cooperatives, BMT	**2,938**	**400**	**46**	**73**	**51****
Total	**40,527**	**11,443**	**1,659**	**11,093**	**4,787**

*Adapted from Appendix 1, Table 1. Estimate of number of deposit accounts based on Timberg 2003: 7.
**Timberg (2003: 7) reports outstanding amounts of Rp 187bn by 2,470 BMT as of June 1998.

Not separately listed in the above statistics are 1,500, mostly rural, financial cooperatives (*Kopontren*) connected with Islamic colleges (*Pesantren*) and registered with the MoC. Most of these do not follow Islamic banking practices, and their leadership reportedly does not want to be associated solely with Islamic finance. Only a small number, perhaps 10-20%, have shifted to Islamic banking (Timberg 2003: 7).

Origin and history of selected BMT: There is a paucity of information on Islamic cooperatives. In the following we therefore rely heavily on the four sample BMT visited, fully aware of the pitfalls of an extremely small and unsystematic sample.[28] All four were selected by ASBISINDO and, for reasons of time constraints, all are located in western Java, three in the province of West Java and one in Jakarta (see Appendix 5, Table 2).

BMT At-Taqwa in Kemanggisan, West-Jakarta, was first established in 1994 as a pre-cooperative under the name of Baitul Maal Wat-Tamwil (BMT) At-Tawqa by four representatives of the Mosque At-Tawqa . The initiative had been taken by the management of the Mosque At-Taqwa and an employee of BMI in the neighborhood. The initiative was part of PINBUK's program of establishing Islamic cooperatives, which also provided training. The start-up capital of Rp 23mn was provided by Yayasan Taqwa Bakhti which manages the Mosque, comprising Rp 5mn in cash and Rp 18mn in equipment. In 2000 it registered as a cooperative under the MoC, with 1,500 members. As of early 2004, it had 4,000 members.

BMT Ibaadurrahman in Sukabumi was established in 1992 as a BMT unit in a multipurpose cooperative of a *Pesantren*. In response to popular demand, it started with a membership of 1,500 and now has 3,000 members. It has been registered as a savings and credit cooperative unit (USP) within a multi-purpose cooperative since 1992.

BMT Latanza in Garut was set up in 1996 as a self-help group (SHG) called Kelompok Swadaya Masyarakat (KSM) through PHBK, Bank Indonesia's *Program Linking Banks and Self-Help Groups*. It was initiated by young people in town, inspired by PINBUK, which also suggested the cooperation with PHBK. It comprises 800 members organized in 80 SHGs. 20 of the SHGs are active borrowers; 60 are savings groups only. In 2000 it registered as a KSP with the MoC.

BMT Wira Mandiri in Tasikmalaya was established in 1997 as an SHG. Later in the year it changed its status to a BMT and was registered as a cooperative of employees of Yayasan Wira Mandiri (YWM), a foundation. In 1999 it was registered as a Koperasi BMT (KBMT) with a broader membership for the purpose of savings and credit activities. Its founding organization, YWM, which had been established for the promoting Islamic education, is now dormant, but lives on in the BMT*.

5.2 Regional distribution

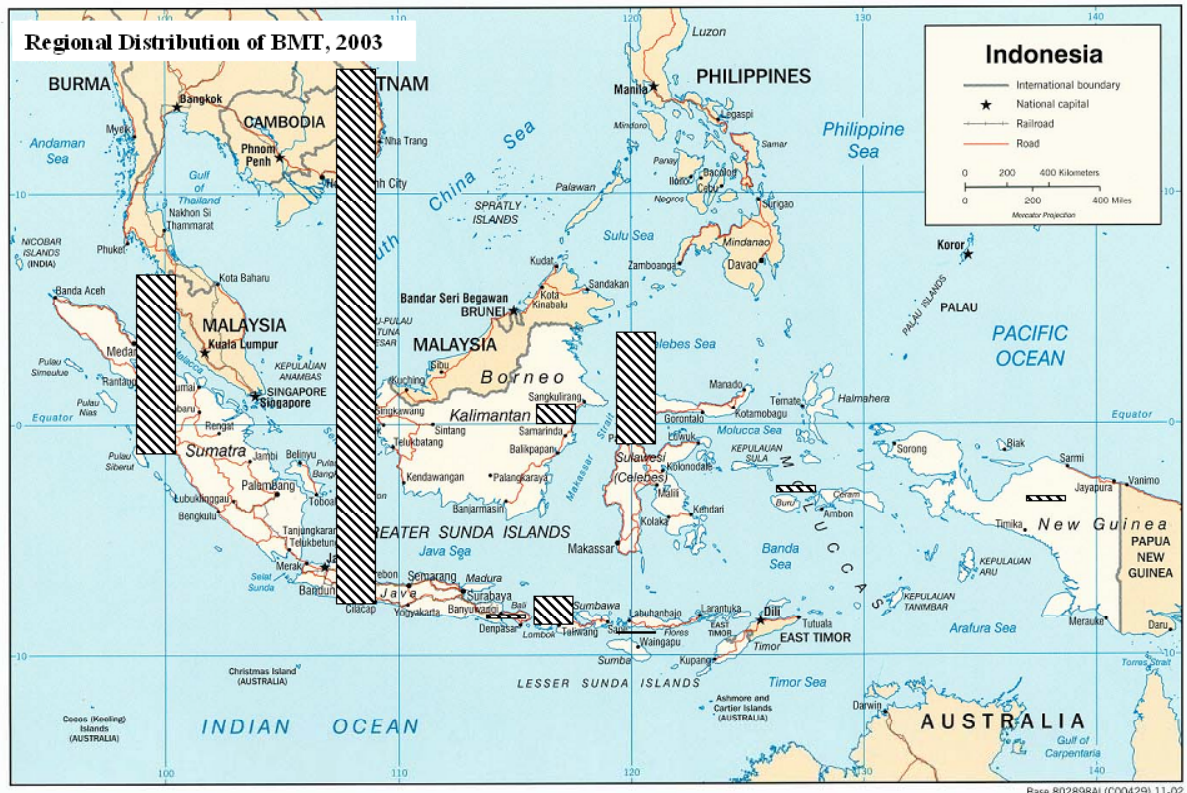
PINBUK has provided a table and map of the regional distribution of BMT for December 2001. The data for 2003 are based on changes manually inserted during our visit and need to be verified. According to this information, the total number of BMT has declined by 6.0%, down from 3037 reported as of December 2001 to 2856 as of December 2003 – after having recorded exceptional growth rates during the crisis years of 1997/98 followed

[28] An additional case study of a BMT in Metro Lampung has been reported by ADB 2003 (Supplementary Appendix C, p. 21), with 53 members, 700 borrowers with an average loan size of Rp1.75 million, and 1,800 depositors.

by a slowdown in growth during the period 1999-2001. The number of members and customers of BMT is reported to have stagnated or declined in recent years (see ADB 2003 (Supplementary Appendix C, p. 21)).

The majority of BMT (65% in 2001 and 60% in 2003) are, like BPRS, located on Java where they are far more equally spread than BPRS over the western, central and eastern parts. Large declines in numbers are reported for Jakarta, West Java and East Java, while numbers in Central Java and D.I. Yogyakarta have increased (provided of course that the numbers for 2003 are correct). On Sumatra, their share has increased from 16% to 20%, with large jumps in North Sumatra and Riau. The share of BMT in the other regions changed little between 2001 and 2003. Compared to the number of registered KSP/USP (40,639), BMT are somewhat over-represented on Java, Sulawesi, Sumatra and West Nusa Tenggara, and under-represented on Kalimantan and the smaller islands (see Appendix 5, Table 3).

Of the 3,037 registered BMT as of 2001, 2,025, or 67%, are reported by PINBUK as reporting. For 2003 PINBUK has published a directory of 1,257 BMT, containing their full name and address, phone number, and the name of the manager. This may be taken as another indicator that only around one-third of the BMT are active.

Map 2: Geographical distribution of BMT, 2003

5.3 Mission, legal status and governance

Mission: The BMT in our sample see it as their mission to help the enterprising poor in the vicinity and to empower them economically. Their particular target market are very small micro-entrepreneurs including itinerant traders and food vendors (*kaki-lima*). ADB 2003 (Supplementary Appendix C, p. 21) reports that the majority of BMT customers are urban-based and provide services to both poor and non-poor households. The size of shares varies widely. In BMT At-Tawqa, with 4,000 members, a share is Rp 10,000, little more than US$ 1; in a BMT in Metro Lampung visited by ADB 2003, with only 57 owner-members but 1,800 customers, the size of share is Rp. one million (US$118).

Legal status: According to Bank Indonesia, only about 500 of the 3,000 BMT are registered as KSP with the MoC. All others are regarded as "pre-cooperatives". With reference to the draft MFI law of 2001, BMT are considered by PINDUK as sharia MFIs (*Lembaga Keuangan Mikro Syariah,* LKM-S), which may be considered as semiformal institutions: recognized but not regulated. All four sample BMT in our study are registered with the MoC.

Ownership: As cooperatives, they are owned by their members. BMT At-Tawqa and BMT Ibaadurrahman stated that they have 4000 and 2500 member-owners, respectively. However, many BMT make a distinction between members with voting rights and partnership members without. BMT Wira Mandiri, for example, has 45 voting members and 2,000 partnership members. In the case of BMT Latanza, the owners are 80 SHGs with a total of 800 members.

Board and management: Board size and composition of BMT are not standardized. The four sample BMT are overseen by boards comprising between three and 14 members, with an average of seven. They have between one and three managers.[29]

Internal control is generally in the hands of a supervisory board, which either meets monthly or on an ad hoc basis.

External auditing and supervision vary widely. About 500 out of the 3000 BMT are estimated to be registered as cooperatives with the MoC. These are required to send annual reports, formerly to the MoC as the official supervisor; and now, under decentralization, to their respective provincial and district cooperative authority (*Dinas Koperasi*). Their function is effectively limited to registration and the receipt of annual reports. There are no auditing requirements; there is no effective supervision and no enforcement of any norms; and to our knowledge no official closing of non-functioning cooperatives.

[29] BMT At-Taqwa, the largest cooperative, also has the largest board, comprising a sharia board of four, a supervisory (*komisaris*) board of five, a law and management board of four, and an internal control board of one, all of which meet monthly. BMT Ibaadurrahman has a supervisory board of just three members. BMT Latanza has a management board of three, a sharia board of three and a supervisory board of two. BMT Wira Mandiri has a management board of one and a supervisory board of three. Two of the BMT have one, and two have three managers. Management appears to be strongest in BMT At-Taqwa, with a general manager, a manager of operations and a marketing manager; and weakest in BMT Ibaadurrahman, where the manager of the multipurpose cooperative and the BMT unit are identical.

BMTs are expected to provide monthly reports to their regional PINBUK, although only about 50% comply with this, the remaining ones being largely inactive or reporting late. The quality of reporting overall is variable. Furthermore, PINBUK has no formal supervisory powers. There is no performance measure used to assess the institutional quality of each BMT, and there is a high failure rate among BMTs because of weak management (ADB 2003, Supplementary Appendix C, p. 21). PINBUK states that it used to employ ten supervisors, but these left when funding ceased. INKOPSYAH regularly receives monthly reports from its members (as a prerequisite for funding from outside sources). Reporting, though not yet standardized, consists of financial statements. There are no resources for on-site visits. Regional PUSKOP only visit members when invited to do so. MoC officials may attend the annual general meeting at the invitation of the BMT. In general, enforcement, supervisory arrangements, information and reporting are ineffective, although the cooperative authority of Central Java is an exception in this regard.[30]

5.4 Delivery system, market and outreach

No statistical information on the staffing of BMT is available. In the four sample BMT, the average number of staff is close to four, more than half of them loan officers or collectors. The average service radius is about 14 km (see Appendix 5, Table 4).

Information on total membership and customers of BMT is not available. The vast majority of BMT clients are small traders, many of them itinerant, and some other types of micro-entrepreneurs, mostly in urban and peri-urban areas. Of the four sample BMT, only Wira Mandiri includes salary earners and farmers; approximately 40% of clients are women, and 45% are estimated to be below the poverty line (see Appendix 5, Table 5).

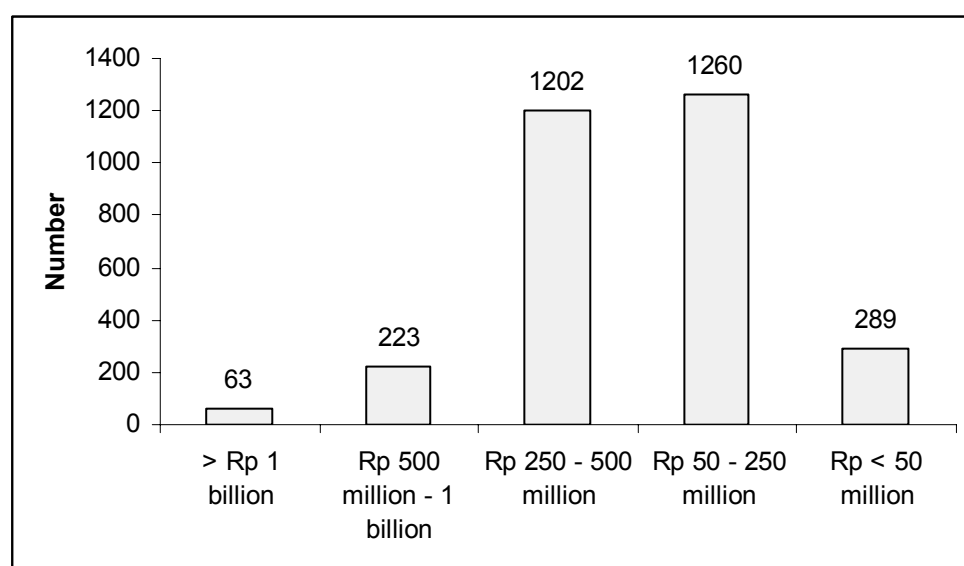
Saver outreach: There is no information on the total number of savers or deposit accounts of BMT. All members and clients of a BMT have a deposit account; the total number of clients usually equals the number of savers or savings accounts, ranging from 800 to 4000 in the four sample BMT, 2325 on average. There is no information on the number of active savers. As the average asset size of the BMT sector is one-quarter the size of our four sample BMT, a reasonable estimate of the average number of depositors per BMT in the sector might be around 580. In this case, total saver and borrower outreach would be 1.66 million; however, if we assume that perhaps only one-third of the listed BMT are active, the actual saver and client outreach may only be 550,000, or even less.

[30] BMT At-Taqwa, the largest of the four BMT, states that auditing and supervision are non-existent; they neither report to the Ministry of Cooperatives nor PINBUK. In contrast, BMT Ibaadurrahman reports every one or two months to its local cooperative authority, from which it has received recommendations and accountancy training; it was last audited in 2002. It also sends monthly reports to BMM, but has not received any reaction. In preparation for refinancing by BMM to the amount of Rp 25 million, it is now audited by BMM. BMT Latenza is not supervised. BMT Wira Mandiri is supervised by PINBUK and BMM, but has never been audited.

The **borrower outreach** of the BMT sector according to Table 1 in Appendix 1 is 73,000, or 25 per BMT, a highly questionable figure. In the four sample BMT, the number of borrowers ranges from 200 and 500 per BMT, yielding an average of 327 (see Appendix 5, Table 6). As the average asset size of the BMT sector is one-quarter the size of our four sample BMT, the average number of borrowers per BMT in the total sector can be estimated at around 80, which would be over three times the size derived from Table 1. Total borrower outreach would then be around 230,000. However, if we apply the same logic as above and assume that only one-third of the BMT are active, actual borrower outreach would be brought down to 76,000 (as of 2003), which is close to the figure reported in Table 1.

5.5 Total assets and sources of funds

In the absence of compulsory registration and reporting, there is no consolidated balance sheet. For 2001 PINBUK has provided a classification of BMT by total asset category. The largest BMT, 2.1% of the total number, had assets above Rp 1 billion (US$ 97,500[31]); 7.3% had assets between Rp 500 million and Rp 1 billion. The smallest BMT, 9.5% of the total number, had assets below Rp 50 million (US$ 4,900); and 41.5% had assets between Rp 50 million and 250 million. 40% were in middle category of Rp 250-500 million (US$24,400-48,800). The median was at Rp 250 million.

Graph 5.1: BMT by asset category, 2001

In terms of total assets, all four sample BMT are above the median of Rp 250mn; the largest, with total assets of Rp 2.2bn, falls into the upper category. Mean total assets are close to Rp 1bn, which is almost four times the median and almost six times the mean size of a registered cooperative, KSP/USP.

[31] Average rate of exchange for 2001: Rp 10,255 to the US$.

Mean loans outstanding in our four sample BMT are Rp 742mn, mean deposit balances Rp 717.5mn. Deposits are thus the main source of funds, followed by capital. In BMT At-Taqwa, the largest BMT, deposits exceed loans outstanding; in BMT Ibaadurrahman and BMT Wira Mandiri, they almost reach the loan volume and, together with capital, exceed the loan volume. Only one of the four, BMT Latanza, relies heavily on borrowings (to the tune of 34% of loans outstanding). The mean loan-to-deposit ratio is 103%. (see Appendix 5 Table 7).

5.6 Financial services

The question about ***the difference between Islamic and comparable non-Islamic institutions*** evoked little response, except in BMT Ibaadurrahman, which claims that profit-sharing is more in the interest of the customers than interest-taking; that average profits are higher for both BMT and customers because of higher transparency; and that customer relations are stronger because of specific suggestions how to improve the business; in one case this reportedly led to an increase in assets from Rp 3mn to Rp 41mn.

Deposits: No statistics on the overall deposit balances of the BMT sector are available. Deposits in the four sample BMT range from Rp 199mn to Rp 1,958mn; the average is Rp 717.5mn. Deposit products are mainly based on *Mudarabah*, ie, revenue-sharing arrangements between clients and BMT. The revenue-sharing breakdown in the case of savings accounts varies from 25:75 to 40:60, averaging 34:66; in the case of time deposits, depending on maturity, from 35:65 to 45:55, averaging 42:58. Average returns p.a. are approximately 8.8% in the case of savings and 13.6% in the case of time deposits: slightly higher than the returns in BPRS of 8.3% and 13.0%, respectively. Two of the sample BMT offer current accounts which are not remunerated (see Appendix 5, Table 8).

Financing (lending): No statistics on the overall portfolio of the BMT sector are available. Financings outstanding in the four sample BMT range from Rp 217mn to Rp 1,819mn; the average is Rp 742mn, or Rp 2.3mn per borrower (compared to Rp 5.4mn per borrower in the five sample BPRS). The average FDR is 103%, the same as in the five sample BPRS.

In contrast to the five sample BPRS where *Murabahah* (a sales contract between bank and customer with a mutually agreed-upon profit margin for the bank) is by far the most important loan product, accounting for 86% unweighted, the loan portfolio of the BMT is more balanced: *Murabahah* financings account for 61.5% unweighted of the loan products and is still the top product; but *Mudarabahh*, the profit-sharing product, accounts for 32.0% and *Qard Al-Hassan*, the interest-free/profit-sharing free product for poor start-up borrowers, accounts for 3.5%. Requiring collateral is standard, comprising the title of a house, land, a car or motorbike, savings, or personal guarantees. Most loan products are tied to savings (approximately 5% of the loan size) as part of collateral. The four BMT offer no other financial services and have no other business (see Appendix 5, Tables 9-10).

5.7 Economic performance

In the absence of effective regulation and supervision, the performance of BMT is quite uneven. An unknown number of the registered and unregistered BMT are dormant. ADB (2003, Supplementary Appendix C, p. 21) found that in Lombok/NTB, an island known for the strength of its SHGs and cooperatives, only 30 out of 93 BMTs are viable. In 2001, only 67% of the registered BMT were listed by PINBUK as reporting. PINBUK estimates that perhaps 900-1,000 BMT are financially viable. Permodalan Nasional Madani (PNM), with a mandate of strengthening BMT and other MFIs, has identified about 500 BMT, or less than one-fifth of the total number, as functioning and worth strengthening.

No data are available on the performance of the BMT sector as a whole. The four sample BMT are very large and not representative of the sector. NPL ratios vary widely from 1.4% to 30.0%, but are mostly estimates. All four BMT show positive returns on year-end assets, with ROAs ranging from 0.16% to 2.70%; however, these figures are unreliable as sizeable bad debts may not have been written off (see Appendix 5, Tables 11-12).

Box 3: Some findings on BMT in ADB's rural microfinance study, 2003

In three regional studies of MFIs conducted by the ADB team (2003), the BRI units came out first as sustainable institutions with wide outreach and excellent performance; in two, the BMTs came out as complete failures, while in the third the BMT, after restructuring and after considerable capital injections, showed promise. BPRS were not found in the sample.

In NTB, ADB studied five MFIs. It found that "the BRI Unit in Selong selects their clients prudently from low income and well-off people… In terms of viability, BRI Unit is the best with 97% loan repayment, making profit of 187 million and has an LDR of 0.72. The second is Credit Union Karya Terpadu […] The remaining three are not viable […] and the worst is BMT Ar Rayada. (ADB 2003, Supplementary Appendix I)

In Donggala District, Central Sulawesi, of five MFIs studied, "only BRI shows a good performance with a loan repayment of 99.1 percent and a loan to deposit ratio of 0.75 […] The BMT Al Amin Palu has completely failed to show at least sufficient performance with a loan repayment (rate) of 5 percent. There was no loan repayment data available on cooperatives." (ADB 2003, Supplementary Appendix IV)

In North Lampung District, Lampung, BRI Unit Kotabumi came again out first; but BMT Fajar was found "potentially sustainable." It was "established in 1996 as a group managed by 5 members named Kelompok Swadaya Masyarakat (KSM). By 1997 the membership had grown to 31 persons and became a cooperative. The capital originated from share savings of Rp50,000 per member. In 2002 there was a restructuring of the management and only 53 members remain. The capital structure was also amended to Rp1 million for share saving and Rp5,000 contractual savings for each member per month. Besides capital from members, this BMT has twice received loans from PNM, Rp75 million and then Rp260 million. The funds have been on-lent to 700 members. There are 1,800 total savings accounts. BMT "*Fajar*" is potentially sustainable as total borrowers already reach 700 and there are 1,800 saving accounts among a population of 135,000 people in the 5 sub-districts in its operational area. NPL is 9 percent and efforts are continuing for a further reduction." (ADB 2003, Suppl. App. V)

5.8 Affiliations and support

PINBUK: The most important promoter of Islamic cooperatives is PINBUK, the Centre for Micro Enterprise Incubation, *Pusat Inkubasi Bisnis Usaha Kecil*, established in 1995 by the Yayasan Inkubasi Bisnis Usaha Kecil (YINBUK) foundation as its operational arm. PINBUK has no legal status of its own, but is operationally autonomous. It facilitates the establishment and licensing of new BMT, which usually receive first a certificate from PINBUK as a pre-cooperative (*prakoperasi*) or self-help group (*kelompok swadaya masyarakat*), before registering with the MoC (which most do not do). PINBUK provides basic, intermediate and advanced training, plus training of trainers. It offers a wide range of training modules. The seminars are organized by PINBUK with trainers certified as Master of Training with support from the government, colleges/universities and non-governmental organizations (NGOs) (e.g. MERCICORP). Additionally, Pinbuk has published manuals for the establishment of BMTs; regulations and statutes of BMT; management; computerization; and performance assessment. It is the only organization that provides statistics on BMT but, with its small staff, is unable to do so regularly. The last official statistics, reporting 3037 BMT, date back to 2001.

PINBUK also supplies BMT with Management Information Systems (MIS). Along with TCTECH (TAMWIL Computerization Technology, Semarang) and since 2001 with PT USSI in Badang, PINBUK has developed a software package for BMT, divided into three categories: Single User, for small scale BMTs, at the price of Rp 1.5 million; Multi-user with Local Area Network capability for medium sized BMT, at the price of Rp 3.5-10.0 million (depending on asset size); and an advanced version with on-line long distance network functionality (between head-office and branches) for large scale BMTs at the price of Rp20 million.

PINBUK operates at the head office with a staff of 14 in Jakarta. Since 1999, it has been establishing chapters at the district level, so that primary BMT can join the district chapters. This has now been achieved in 250 out of 360 districts, each a one-man operation. Some 18% of the PINBUK district offices have a business development officer responsible for BMT development and monitoring, but many of these staff are also involved in other activities.

PINBUK receives basic funding from YINDUK, which is itself funded from donations. Additional funding is provided by the Ministries of Social Affairs, Cooperatives, and Transmigration for special projects, e.g. for establishing BMT in transmigration areas. The costs of training are covered from fees paid by the BMT. In some districts (approximately 5 out of 250), the BMT (roughly 100) pay regular monthly contributions to the district office; this system is expected to be expanded.

INKOPSYAH: Induk Koperasi Syariah is a parallel institution which has been registered as a secondary-level cooperative since 1997, with a national office of nine staff members in Jakarta. It functions as a wholesaler of funds from PNM and PUKK, the Small Enterprise Development Fund (which receives contributions from the 5% profit share that state enterprises have to devote to poverty alleviation and small enterprise development);

it monitors the loans, but leaves technical assistance in the hands of PINBUK. INKOPSYAH has some 500 primary-level BMT members registered with the MoC as cooperatives. To qualify as a member, total assets have to exceed Rp 500m. At the regional level, INKOPSYAH works through regional secondary cooperatives, Pusat Koperasi Kredit Syariah BMT (PUSKOP), which cooperate with PINBUK. The main function of the PUSKOP is to facilitate BMT access to credit. They are also responsible for monitoring both members and BMT that are non-members. For example, the central Java PUSKOP employs seven staff and funds its operations from fees from BMT for training and the sale of software; it also retains some margin on long-term loans (from the apex through PUSKOP to BMT), and from its ownership of five retail shops. At the end of September 2002, INKOPSYAH had total assets of Rp 2.6bn, with the major funding coming from PNM in the form of a five-year subordinated loan of Rp 2bn at 19% interest p.a. In 2003 INKOPSYAH was instrumental in channeling Rp 15bn from PNM to BMT. It reports a good repayment performance and a profit of Rp 300m in 2003.

PNM: Permodalan Nasional Madani, is a commercially operating[32] state-owned corporation, acting as a wholesale apex for financing small and medium enterprise programs or projects of commercial banks, rural banks (BPR) and cooperatives. While Bank Indonesia's functions have been concentrated on monetary policy, its various development banking functions have been divested in various other institutions, among them PNM as a replacement for BI's Liquidity credit program, KLBI, since June 1999. In cooperation with ASBISINDO and PINBUK, PNM also supports Islamic financial institutions: commercial banks, rural banks and cooperatives.[33] The 85 BMT which are PNM borrowers are all registered with the MoC. The remaining 2,500 are either dormant or weak. They require strengthening through (i) prudential regulation and effective supervision, which is the government's task; (ii) capacity-building, which is presently done by PINBUK but should be the task of associations of BMT; and (iii) financial development by wholesale institutions such as PNM. In the absence of supervision, PNM, which has a vested interest in quality, has taken steps to set up a supervision team; its functions and authority are being discussed with the MoC. In the future PNM plans to put more emphasis on human resource development in BMT in cooperation with PINBUK and ASBISINDO, thus providing both financial and social capital. It is hoped that PNM's own quality management system[34] will eventually reflect on* the BPRS and particularly the BMT, which it refinances.

Bank linkages have been emerging, particularly with BMI and Bank Mandiri as well as with PNM as a wholesale apex. In 2002 Bank Mandiri allocated Rp 39.6 billion for on-lending to BMTs, provided through the Himbara Funds, taking 3% of its annual profit under the PUKK program. As of December 2002 the total amount disbursed through PINBUK at an interest rate of 6% p.a. was Rp 147 billion for 47,000 BMT members. The

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[32] In 2003, total assets reached Rp 1.96tr, equity was Rp 415bn, ROA 3.5%, and ROE 16.3% (PNM 2004: 66-69).

[33] PNM, as of December 2003, had 652 microfinance customers: 432 BPR and BPRS (out of a total of reportedly 1,200 healthy rural banks); 135 KSP/USP (out of a total of 2,500 healthy cooperatives); and85 BMT (out of a total of 500 healthy Islamic cooperatives).

[34] ISO 9002-certified by TÜV.

Bank has also conducted training for BMT staff. The major constraint for Bank Mandiri in assisting the BMTs is that most have no legal status and are not registered as cooperatives.

Muamalat Institute: In order to strengthen Islamic commercial and rural banks, BMI has established the Muamalat Institute for Research, Training, Consulting & Publication. For banking with the poor organized in BMT and *Kopontren*, BMI has established Baitulmaal Muamalat, which focuses on channeling funds from the MoC to Islamic cooperatives.

In addition to formal financing arrangements, BMTs receive substantial donations from wealthy Muslims. Management and supervision weaknesses are the major constraints for BMT, not funding.

Microfin is an agency established in 2001 with the objective of channeling funds to BMT and *Kopontren* and facilitating their evolution into MFIs (LKM) according to the draft microfinance law of 2001, or inducing them alternatively to establish BPRS. It is funded from channeling fees of government projects, executing profit margins from commercial banks and profit-sharing from individual investors. It has ten staff members. Microfin has established a network of 109 BMT and participates in a program of channeling funds through seven projects to a total of 673 BMT and *Kopontren*, plus 24 BPRS (December 2003).[35] Its future plans are to stimulate the establishment of additional BPRS, mainly by inducing groups of five to ten BMT to join together and establish BPRS, which are owned by larger numbers of shareholders.[36] Another approach is for one large BMT to establish a BPRS for larger-scale commercial loans, while continuing as an unsupervised BMT for very small loans and for the provision of social activities to the unbankable.

Affiliations of sample BMT: BMT At-Taqwa has no network affiliations, but follows the PINBUK format of reporting. It has received soft loans from BMI and PNM, and is affiliated to two religious institutions: the At-Taqwa mosque, its founding institution; and Badan Amil Zakat, a religious tax management institution which provides soft loans free of charge. BMT Ibaadurrahman is affiliated to BMM and BUMN (Badan Usaha Milik Negara), two financial institutions from which it received financing of Rp 25m and Rp 33m, respectively, through the local cooperative authority. It has been registered with PINBUK since 1998,

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[35] The first two are government projects, the next two projects with commercial banks, the fifth is an NGO project, and the last two are projects with individual investors:

- P2KER, which has channeled Rp 47bn from the MoC since 1997. Outstanding loans are Rp 12.8bn, and overdue oness 55% (because these are government funds considered as grants);
- DBS, established in 2003, with Rp 3bn outstanding invested in revolving funds; overdues are still 0%;
- M3M established in 4/2004, with Rp 3bn outstanding;
- LFM since 4/2004, with Rp 5.5bn outstanding;
- IDF since 2000, with 0.2bn outstanding loans; overdue loans amount to 0%
- Deposito Mikro (term deposits of Microfin) have amounted to Rp 100 million since 2000,
- Invest Perorangan, since 2002, amounting to Rp 400 million; overdue amounts are 0%.

[36] The establishment of BPRS Sahid by 19 BMT is reportedly in progress in Tulung Agung, East Java. A feasibility study is in process; Rp 500m has been collected; licensing is expected as of mid-2005.

but has received no services. It is attached to the local *Pesantren*. BMT Latenza is unaffiliated. BMT Wira Mandiri belongs to the PINBUK network and is an active participant.

6. Assessment and recommendations

6.1 Assessment

Indonesia, the largest Muslim country, has a highly complex microfinance and rural finance sector which has evolved over more than a century. The modern concept of Islamic finance first emerged in 1991, comprising Islamic commercial banks and banking units, rural banks, and financial cooperatives. These three sub-sectors differ widely in their performance and prospects. This study has focused on the latter two, which together comprise Islamic microfinance.

Islamic finance, after 13 years, accounts for a mere 0.74% of total assets of the banking sector. However, since Bank Indonesia officially recognized a dual banking system, conventional and Islamic, in 1998, interest in Islamic meso and macro finance has spread among **commercial banks**, fuelled by low rates of non-performing loans – not surprising, perhaps, given the attention paid by bankers to this new market segment and a more careful selection of borrowers. As a result, the share of Islamic commercial banks more than quadrupled over the period 2001-2003 from 0.17% to 0.74%. The performance of the Islamic banks and banking units has motivated an increasing number of banks to announce the opening of Islamic banking units. Continued growth in the Islamic commercial banking sector may be expected; however, given present trends, the sector is unlikely to occupy more than a niche in the overall Indonesian banking system in the foreseeable future.

Islamic rural banks (BPRS) are under the same effective prudential regulation and supervision as commercial banks and conventional rural banks (BPR). After a promising start in the early 1990s, their development has almost come to a standstill. Despite the fact that they had only two years less than conventional BPR, they have attained a mere 4.0% of the number and 1.5% of the assets of the rural banking sector. After 13 years of development of Islamic rural banks and 15 years of development of a regulated rural banking sector in Indonesia, Islamic rural banks still constitute a minute part of the rural banking sector as well as of the total Islamic banking sector, with no growth prospects if current trends are extrapolated**.** Overall, the Islamic rural banks constitute:

- 4.0% of the total number of rural banks (BPR/S)
- 1.5% of the total assets of the rural banking sector, and just 0.02% of the total banking sector
- 2.4% of the total Islamic commercial and rural banking sector assets
- 1.5% of total loans outstanding, and 1.2% of total deposits, of the rural banking sector
- 1.5% of the outreach of the rural banking, and 0.14% of the microfinance, sector.

Islamic rural banks, compared to conventional rural banks, have not passed the test of history, albeit a short one, as a comparison shows:

- Regulated Islamic and conventional rural banks have evolved over almost the same time period, 13 and 15 years, respectively
- Islamic rural banks have remained small. The volume of their services is negligible, compared to conventional rural banks, accounting for only 4% in number, 1.5% in assets as well as outreach, and 1.2% of deposits
- Their growth in terms of numbers has stagnated in recent years; and asset growth remains far behind that of conventional rural banks.
- Islamic rural banks are plagued by numerous governance and management problems: many have been established by absentee owners for moral reasons and are managed by retired conventional bankers, who lack dynamism and Islamic banking expertise – with dire consequences for the banks' performance.
- Among the many reasons for the slowdown in development, the following can be highlighted: the lack of popular demand for Islamic banking services, absentee ownership, the absence of a young dynamic management, the lack of mastery of extremely complex Islamic banking practices, and emphasis on the informal sector and the poor to the neglect of more profitable market segments.

Islamic financial cooperatives (BMT) suffer from the same regulatory and supervisory neglect as the rest of the sector. After a period of rapid growth during the 1990s, they are now in decline, with perhaps only one-fifth in good health. In the absence of effective supervision, reliable data on both Islamic and conventional cooperatives are missing. The outreach of Islamic cooperatives is negligible, and their overall performance poor:

- There is a complete lack of regulation, supervision and reliable reporting
- Most are reported to be dormant or technically bankrupt
- Their outreach is negligible, accounting for 7.20% of all financial cooperatives, but less than 1% of the borrower outreach of the sector
- Their loan portfolio (much of it overdue) accounts for 1.10% of the financial cooperative sector and 0.19% of the microfinance sector
- The savings of depositors are at great risk.

A comparison of Islamic and conventional financial cooperatives reveals that both have been doing poorly:

- The whole cooperative sector has historically suffered from a complete lack of regulation and supervision, paralleled by excessive government interference and subsidies which have distorted rural financial markets and undermined self-help.
- The majority of Islamic cooperatives are reportedly dormant or technically bankrupt.
- Outreach and volume of services of Islamic cooperatives are negligible compared to conventional cooperatives, which are also in a state of acute ill-health.
- The savings of depositors are at great risk; cooperatives should not be authorized to accept savings of non-members.
- No remedy is in sight, except perhaps in the framework of a total overhaul of the cooperative system, which in fact is now under serious discussion.

- We warn that, fresh money pumped into the sector by donor or government agencies without effective regulation and supervision will contribute to their downfall rather than redemption, as has been the case in the state-supported cooperative sector.

Islamic financial products do not seem to have any particular attraction to Islamic financial institutions and their customers in Indonesia. Revenue-sharing in deposits (*Mudarabah*) is unduly complicated and little appreciated because of monthly fluctuations and annual ex post calculations; remuneration-free *Qard al-Hasanah* deposits, which are very important in Iran, are non-existent in Indonesia. Profit-sharing in lending (*Mudarabah*), which should be the backbone of Islamic banking, constitutes but a small part of the portfolio, as it does in Iran. *Qard al-Hasanah*, remuneration-free lending to the poor, is virtually non-existent in Indonesia. The largest part of the portfolio is trade finance at a fixed margin (*Murabahah*), as is the case in Iran and among the *Sanadiq* (village funds) in Syria. However, this is again unduly complicated and increases transaction costs because it involves two contracts by the bank: one with the seller, and one with the borrower. Moreover, the managers in Islamic institutions have not fully mastered the art of Islamic banking. The strength of Islamic finance lies in its conservative character: only real transactions, and not speculative investments, are financed. This keeps financing to start-ups and micro-entrepreneurs without collateral to a minimum.

In sum, Islamic microfinance, lacking popular demand and Islamic banking expertise, has so far been more a political than an economic project in Indonesia. Only commercial banks appear to be capable of acquiring the art of Islamic banking by training young and dynamic people, but they lack experience in Islamic microfinance. Islamic rural banks, unlike conventional ones, have failed to prove themselves to be effective and efficient providers of microfinance services. The picture is even worse for Islamic cooperatives, like conventional ones, which are an outright menace, to the extent that their shareholders and depositors risk losing their money. Based on the above facts, and after 13 years of experience with Islamic finance in Indonesia, decision-makers in favor of promoting Islamic financial services have two major options:

1. To focus on Islamic commercial banks in Indonesia and to assist them in establishing branch networks offering Islamic microfinance products.

2. To reassess in a participatory process the challenges and realistic opportunities of Islamic rural banks and cooperatives, taking into consideration the lack of broad popular demand and the lack of dynamic growth.

6.2 Recommendations

Risks and constraints: It is beyond the scope of this preliminary study to submit a definitive recommendation as to which of these options is preferable. However, policymakers should be aware that Islamic commercial banks are on the right track, and are becoming a healthy and growing sub-sector of commercial banking. That potential could be further utilized to give them a stronger role in microfinance. Examining their

strengths and weaknesses was not part of this study; however, there was sufficient evidence to arrive at the conclusion that they are already standing on their own feet and are developing, both in quantitative and qualitative terms. Nevertheless, Islamic banking, with its variable and flexible ratios of revenue-sharing with depositors and profit-sharing with borrowers, is excessively complicated, and only commercial banks appear to be capable of acquiring the art of Islamic banking by training young and dynamic people.

The same cannot be said of the Islamic rural banks and the Islamic cooperatives: the former – in contrast to conventional BPR – have failed to prove themselves as effective and efficient providers of microfinance services, while the shareholders and depositors of the latter run a high risk of losing their money. Most BPRS are run by retired conventional bankers (Bank Indonesia regulations state that only experienced bankers can be hired) who find it difficult to learn and apply the rules of Islamic banking; and their sharia boards are frequently not any more experienced in this regard.

Opportunities: We recommend that decision-makers in Islamic organizations, government agencies and donor organizations should examine critically the following opportunities for the development of a healthy Islamic financial sector in Indonesia:

- **Islamic commercial banks**, by setting up branch networks of Islamic MFIs, may profitably learn from the rich experience of successful microfinance strategies and institutions within Indonesia, in particular:

    1. from the experience of the units of the Bank Rakyat Indonesia Microbanking Division, one of the most successful microfinance programs in the developing world; and
    2. from Bank Indonesia's program *Linking Banks and Self-Help Groups*, a financial technology of extending the outreach of banks to low-income people at reasonable transaction costs (an approach which has inspired NABARD in India to link 1.6 million SHGs with 24 million members of the rural poor to some 35,000 bank branches (see Seibel 2005)).

- **Islamic rural banks** need to be revamped if they are to play a more than marginal role in Indonesia. This requires an overall development plan for the BPRS sector mutually agreed upon by all stakeholders. With some reservation, due to poor prospects if there is anything to be learned from past history, we recommend to the stakeholders the following:

    1. Establishing a strong banking association to provide a full range of support services to their members on a cost-covering basis; a much-strengthened ASBISINDO, perhaps in cooperation with GTZ's ongoing microfinance Project (ProFI), may promote such an association or provide those services ad interim
    2. Selecting some of the most successful Islamic rural banks as demonstration and exposure learning sites, to provide apprenticeship and extended exposure training to staff and future managers

3. A farther-reaching option would be a dual training system to prepare young dynamic graduates for management positions (instead of relying on elderly retired bankers)
4. Developing more effective savings products and strategies as a partial substitute for borrowings and savings-cum-credit products
5. Mandatory auditing should be extended to all BPRS, regardless of size
6. Bank Indonesia should be encouraged to continue providing guidance, enforcing prudential rules and closing defunct BPRS.
7. For the rapid expansion of the BPRS network, the many absentee owners may be interested in a *Build-Transfer-Operate* approach, perhaps as part of a franchising model, with profit-sharing between the franchiser and the franchisee.

- **Islamic cooperatives** suffer from much the same set of problems as the whole cooperative sector. There is little chance for any intervention to be successful in the short run:

1. Islamic cooperatives most urgently need a system of prudential regulation, mandatory auditing and effective supervision by an appropriate financial authority (perhaps delegated to an autonomous auditing federation, but definitely not in the hands of a ministry).
2. They should be fully financed through member equity and savings deposits of members; only healthy and well supervised cooperatives should be permitted to collect deposits from non-members.
3. They should develop more effective savings products and strategies as a substitute for borrowing.
4. The services of organizations whose sole purpose is channeling project funds should be phased out.
5. Like Islamic rural banks, Islamic cooperatives need strong associations and federations to provide a full range of support services to their members on a cost-covering basis; a much-strengthened PINBUK is one of the organizations that may promote such associations or provide those services ad interim
6. Associations may be strengthened to eventually replace a governmental agency like the Ministry of Cooperatives, which, in the framework of massive government interference under the previous political system, seems to have had a more detrimental than constructive effect in terms of building self-reliant, healthy cooperatives.
7. Some of the most successful Islamic cooperatives may be selected as demonstration and exposure learning sites, providing apprenticeship and extended exposure training to staff and future managers.

6.3 Postscript: Islamic finance in the province of Aceh after the Tsunami

Of all areas devastated by the Tsunami, the province of Aceh has been the hardest hit. Providing relief and reconstructing the livelihoods of the surviving victims is the immediate task; reconstructing the physical and institutional infrastructure will have to come next. If

the reconstruction efforts are to lead to sustainable development, rural finance and microfinance will have an important role to play. For political reasons, Aceh has been isolated in the past from mainstream development. The challenge is thus not just reconstructing, but also laying the foundations for a sound system of rural and microfinance institutions. All the inhabitants of Aceh, particularly those impoverished by the floods, need access to sustainable financial institutions in order to deposit savings, including relief benefits, and to obtain credit. Relief benefits are likely to be wasted, or limited in their effectiveness, if victims have no access to financial services (see Seibel 2003a). The people of Aceh adhere to the principles of Islam, including Islamic finance. Aceh already has five Islamic rural banks and 76 Islamic cooperatives. This is a beginning, but not an adequate structure in terms of Islamic finance. Building strong Islamic financial institutions in Aceh could be of enormous benefit to the reconstruction and development of the province. Thereby Aceh could become the province benefiting most from the results of this study on the positive and negative experience of Islamic finance in Indonesia.

7. Summary

1. Financial sector framework

Indonesia possesses **one of the most complex microfinance infrastructures** in the developing world, going back more than 100 years. In the increasingly liberal policy environment of the past two decades, two types of *regulated microfinance institutions*, belonging to the formal banking sector, have gained prominence on the microfinance market:

- the units of the Microbanking Division of government-owned BRI, since 1984, and
- the rural banks (BPR), since 1988.

Together, they account for 95% of recorded deposits and 75% of loans outstanding among a total of 53,000 formal and semiformal MFIs. *Financial cooperatives,* which are unregulated semiformal financial institutions, about 40,000 in number, account for another 5% of deposits and 18% of loans; they have suffered, rather than benefited, from preferential government treatment.

Microfinance is no panacea; but it has certainly contributed to the *reduction of poor* from 60.0% in 1970 to 11.5% in 1996. The financial crisis of 1997/98 interrupted this trend; poverty rates surged, but then fell again below 20%. At the same time, the BRI units emerged strengthened, the rural banking sector restructured from the financial crisis, the latter responding positively to the enforcement of prudential regulation. The cooperative sector, much of it presumably in an undiagnosed state of ill health, continues to be effectively unregulated and unsupervised. A major challenge to the commercial banking sector including the BRI units is *surplus liquidity* and thus the development of more effective lending instruments; a parallel challenge among rural banks and financial cooperatives is *liquidity shortage* and thus either the development of more effective savings mobilization instruments or more effective mechanisms of liquidity exchange.
Some of the **highlights of the financial sector framework for Islamic banking and microfinance** in Indonesia are listed below.

A conducive policy environment for Islamic banking and microfinance in Indonesia:
- A long history of banking and microfinance, dating back to 1895
- A highly complex rural financial infrastructure
- A deregulated policy and institutional framework (since 1983)
- An appropriate commercial and micro-banking legal framework
- Favorable central bank regulation for Islamic banks
- BRI units, a most successful microfinance network, as benchmark institutions
- Restructuring of the banking sector in response to the Asian financial crisis
- Increasingly effective prudential regulation and bank supervision
- A major potential market for Islamic finance in the largest Muslim country in the world
- Key question: Is there effective demand for Islamic financial services?

Lack of a conducive sectoral framework for Islamic cooperatives:

- Lack of prudential regulation of financial cooperatives
- Lack of effective supervision of financial cooperatives
- Market distortions resulting from access to subsidized sources of finance
- Massive government interference in the past, although there are some recent signs of relaxation
- The cooperative sector is in an undiagnosed state of ill-health
- Key question: Is there a chance for sustainable Islamic cooperatives in Indonesia?

2. Principles and typology of Islamic finance

Based on Islamic law, or sharia, Islamic finance seeks to fulfill the ideal of a social order of brotherhood and solidarity, more specifically of a mutually beneficial partnership between depositor-investors, owners and staff of financial institutions, and borrower-investors, who all share risks and benefits in various ways. It finds its purest expression in *Mudarabah* deposit products, based on revenue-sharing, which are pervasive among commercial and rural banks, and *Mudarabah* financing facilities, based on profit-sharing partnerships, but adopted on a limited scale only. Most financing transactions are based on *Murabahah*, a sales contract with a fixed profit margin for the bank. The overall emphasis is on financing only profitable investments, backed by collateral. Speculative and other morally hazardous financial transactions including start-up financing and consumer lending are prohibited.

Islamic MFIs in Indonesia take it as their mandate to help the poor. Mistakenly, this has led many to believe that loans are akin to grants, or at least that leniency may be exercised in meeting repayment obligations. In many cases, bank staff and borrowers have had to learn the hard way that this is not so. Islamic MFIs do target the poor, but in actual fact only a segment of the poor: the enterprising poor. Lending to the poorest who lack resources and entrepreneurial experience would be hazardous and speculative; it would thus be contrary to the notion of a partnership between borrowers and the providers of capital: depositors and bank owners. There is yet another market segment served by them: that of the enterprising poorest who lack experience but show promise. For these, some institutions offer another financial product, albeit on a very small scale: *Qard* (or *Qard al-Hasanah*), repayable in regular installments and frequently backed by personal guarantees, but without a bank margin. Even rarer are *Qard* savings in Indonesia, usually for religious or social purposes. Below are some of the **distinguishing characteristics of Islamic finance**.

Principles of Islamic banking – in contrast to conventional banking:

- A social order based on cooperation, brotherhood and solidarity – in contrast to a social order based on competition which permits exploitation.
- Mutually beneficial partnerships between banks and clients, depositors and borrower-investors – in contrast to diverging interests of the parties involved in transactions.
- Symmetrical information-sharing (as an ideal) – in contrast to asymmetrical information (assumed to be withheld by the borrower in order to cheat the bank).

- Trust and confidence – in contrast to moral hazard, which poses a constant threat in conventional banking.
- Financing solid real transactions – in contrast to speculative and hazardous transactions.
- **Key concepts:** Cooperation vs. competition; partnership vs. risky or exploitative relations.

Typology of Islamic financial products :
- Mudarabah as a credit or deposit product based on mutually agreed-upon variable ratios of profit or revenue sharing (this is however difficult and costly to administer) – in contrast to fixed interest rates (which is transparent ex ante and simple to administer).
- Murabahah as the main credit product, a triangular sales contract in which the bank pays the seller and finances the buyer at a fixed margin – in contrast to a direct loan to the client at a fixed margin (at lower administrative but higher risk costs).
- Qard Hasan interest-free or profit-free deposit products (rare in Indonesia) are the purest expression objecting against interest-taking (riba) – non-existent in conventional banking
- Qard Hasan interest- or profit-free credit products are a pure form of social banking, either for charitable purposes or for start-up entrepreneurs without business experience and collateral – there is no equivalent in conventional banking
- Collateral as proof of a serious business relationship – again a safeguard against risk.

Mandate and target group of Islamic MFIs:
- Helping the enterprising poor – in contrast to maximising profits from the most promising market segments

Special risks in Islamic finance:
- (Mis-) Interpreting brotherhood and partnership as leniency and loan forgiveness, resulting in loan delinquency (due to unwillingness to repay) – in contrast to seizing collateral in case of loan delinquency, resulting in bankruptcy (due to inability to repay).

3. The beginnings of Islamic finance in Indonesia

Islamic finance in Indonesia has evolved since 1991, mainly in response to political demands from Muslim scholars and organizations for sharia-based financial services, as a complement to conventional forms of finance in the largest Muslim country in the world. The first Islamic rural banks were established in 1991, followed by the first Islamic commercial bank in 1992. In 1998, Bank Indonesia gave official recognition, as part of the new Banking Act, to the existence of a dual banking system, both conventional and Islamic, or sharia-based. This led to the establishment of a second Islamic commercial bank and, by December 2003, of eight Islamic commercial banking units (out of a total of 138 commercial banks), comprising a total of 255 banking offices. Overall, Islamic commercial banking is on a continuing upward trend. However, the growth pattern of

Islamic rural banks has been quite different. After an initial period of growth, totaling 71 in 1996, their number stagnated as a result of the financial crisis, reaching only 78 by 1998 and a mere 84 by 2003 (out of a total of 2,134 rural banks). The first Islamic cooperative was established in 1990. Rapid expansion started after 1996, as a result of promotion by PINBUK, and continued throughout the financial crisis. However, since 1999 the number of cooperatives has also stagnated, peaking at around 3,000 and subsequently declining to less than 2,900 as of 2003 (out of a total of some 40,000 financial cooperatives).

Main points in the **evolution of Islamic finance** include:

- Islamic finance was created due to initiatives led by Muslim scholars in 1991, but not due to popular demand.
- The recognition of a dual, conventional and Islamic, banking system by Bank Indonesia in 1998.
- Islamic commercial banks: continuing upward trend since 1992; 2 Islamic banks and 8 Islamic banking units out of 138 commercial banks as of December 2003.
- Islamic rural banks: Initial growth since 1991 until 1996 followed by stagnation;, 84 out of a total of 2134 rural banks as of December 2003.
- Islamic cooperatives: Start in 1990, rapid expansion after 1996, stagnation and decline since 1999; 2900 out of a total of 40,000 financial cooperatives as of December 2003.

4. Islamic commercial banks in Indonesia

Overview: Islamic commercial banks account for 0.74% of total banking assets (2003); adding rural banks yields the same percentage of 0.74% - minute share; yet a big increase from 0.17% in 2000. In relative terms, (i) Islamic banks lend more of the funds deposited, with an LDR (FDR) of 97% compared to 54% in the total commercial banking sector; (ii) they lend them more successfully, with a gross NPL ratio of 2.3%, compared to 8.2% in the total commercial banking sector. However, due to rapid expansion, the ROA of Islamic commercial banks is only 0.65%, compared to 2.10% in the commercial banking sector. 89% of the deposits in Islamic commercial banks are revenue-sharing deposits. 20% of financing (or loans) is profit-sharing, and 71.5% is fixed-rate trade financing (*Murabahah*), which differs little from conventional banking.

Concluding assessment: The performance of the Islamic banks and banking units has motivated an increasing number of banks to announce the creation of Islamic banking units; continued growth may be expected in the Islamic commercial banking sector:

- **The share of Islamic commercial banks is a mere 0.74% of total banking assets.**
- **But they have grown fourfold over the past three years, and their non-performing assets are only a quarter of those of conventional banks: presumably due to their focus on prudent, non-speculative lending (perhaps also due to selective lending).**

- **They have benefited from a much-strengthened role of the central bank in prudential regulation and effective supervision.**
- **Islamic commercial banks may have a good potential in developing sustainable microfinance services of increasing volume and outreach, following the example of the microbanking units of Bank Rakyat Indonesia, a world leader in microfinance.**

5. Islamic rural banks (BPRS)

Overview: Islamic rural banks are part of the regulated and increasingly well-supervised rural banking sector, based on the rural banking law of October 1988. Islamic rural banks started to evolve only two years after conventional rural banks (BPR) came into existence, but at very different speeds: the number of conventional BPR reached 2050 in December 2003, the number of Islamic BPRS 84 – in a predominantly Muslim country! While the number of conventional BPR grew at an average rate of 137 banks per year and the number of newly established BPR at a rate of 85.5 (excluding those that were converted from previously existing institutions), the growth rate of BPRS was a mere 6.5 banks annually. BPRS account for a mere 1.5% of total assets, 1,5% of total loans outstanding and 1.2% of total deposits of the total regulated BPR sector. Moreover, BPRS are much smaller, with only 38% of the assets of an average BPR; and their asset growth rates, at 70% over a three-year period, are much lower than those of the BPR sector at 173%. There are no comparative data on performance. Both sub-sectors have experienced closures in recent years.

Regional distribution: The majority of BPRS (62%) are located on Java, two-thirds of these in western Java. 23% are on Sumatra, and 8% on Sulawesi.

Mandate, ownership, governance and supervision: Most BPRS are privately owned. They have a dual mandate, social and commercial, which may be one of the reasons of their slow growth. Conventional BPR, in contrast, are primarily oriented to profit-making, though their owners may also feel some commitment to the local community. Islamic rural banks cater for the enterprising poor in the informal sector, leaving out the more profitable sectors of salary earners and small entrepreneurs on the one hand, and the poorest on the other. The percentage of clients below the poverty line in four sample BPRS was estimated at 6%. The owners of BPRS are mostly absentees and are rarely involved in the management of the bank. In contrast, owners of conventional BPR are frequently owner-managers. Each BPRS has a sharia board, a management board and a supervisory board, each with its own problems: there is no historical experience with Islamic banking in Indonesia; many of the managers are retired government bankers who lack the drive of private bankers; and the controllers are usually far and remote. Banking supervision is effectively carried out by Bank Indonesia, which has closed four of the 90 BPRS licensed by June 2004.

Delivery system: The four sample BPRS have on average two branches and 21 staff members, half of them loan officers including collectors with door-step services. Incentives

are limited to an annual bonus which is not tied to individual performance. In line with the *Mudarabah* principle, some BPRS are discussing the introduction of profit-sharing between staff and owners as a substitute for a fixed salary.

Market and outreach: There are no statistics on the outreach of BPRS. The total depositor outreach of the BPRS sector may be estimated at 83,000, or less than 1,000 per bank; total borrower outreach at around 30,000, or 350 per BPRS. 84% of the clients in five sample BPRS were small (itinerant) traders and micro-entrepreneurs; around 25% were women. Virtually all clients have an existing business. The very poor are expected to seek employment in a larger enterprise, which might be financed by an Islamic commercial bank.

Total assets and sources of funds: The average BPRS as of December 2003 had total assets of US$ 270,000; the figure for the average conventional BPR is almost three times higher. Deposits are the main source of funds (57.0% of total assets) in BPRS, followed by equity including reserves and current year profits (23.0%), bank deposits (11.5%) and borrowings (4.0%). The LDR in all BPRS is 126%, compared to 103% in the total BPR sector.

Financial services: Revenues of savings deposits are shared in the five sample BPRS between clients and banks, at ratios varying between institutions and clients; the average ratio is 40:60, resulting in an average return of 8.3% during 2003; revenues of fixed deposits are shared at 60:50 on average, with an effective return of 13%. Most financing is based on *Murabaha* (86% of financing in five sample BPRS, unweighted average): a sales contract with a fixed margin, which is better understood by the borrowers and easier to handle for the bank. Installments are monthly or weekly, sometimes daily. The mark-ups are mostly flat rates, averaging 55% effective p.a. among the five sample banks, which is probably close to the average lending rate of BPR in Indonesia; only the BRI units are lower (averaging around 35% effective p.a.). Compared to BMI, the largest Islamic commercial bank, BPRS pay slightly more for deposits, but charge three to four times as much for financing.

Economic performance: No data are available on the performance of the BPRS sector as a whole. The emphasis of BPRS on financing only profitable activities should give them a comparative advantage, their much smaller size, governance problems and market restrictions a disadvantage. In the four sample BPRS, which are far larger than the average BPRS, the average NPL ratio was 4.6% and the average ROA 3.2%, compared to an NPL of 2.5% and an ROA of 5.7% in the benchmark BRI units.

Affiliations and support: ASBISINDO was established in 1992 as an association of Islamic rural banks; since 2002 its coverage has also included Islamic commercial banks. Its main activity is the training of management and staff of Islamic banks. NM*, a government corporation which has replaced Bank Indonesia's small credit department, refinances BPR, BPRS and other financial institutions and supports their capacity-building.

Concluding assessment: After 13 years of development of Islamic rural banks and 15 years of a regulated rural banking sector, Islamic rural banks constitute but **a minute part of the rural as well as of the total Islamic banking sector, with little prospects of growth:**

- 4.00% of the total number of rural banks (BPR/S)
- 1.50% of the total assets of the rural banking sector
- 0.02% of the total banking sector
- 2.40% of the total Islamic commercial and rural banking sector assets
- 1.50% of total loans outstanding of the rural banking sector
- 1.20% of total deposits of the rural banking sector
- 1.50% of the outreach of the total rural banking sector
- 0.14% of the total microfinance sector.

Comparing Islamic to conventional rural banks, we can conclude that :

- Regulated Islamic and conventional rural banks evolved over almost the same period
- Islamic rural banks have remained small. The volume of their services is negligible, compared to conventional rural banks
- Their growth in numbers has stagnated in recent years; and their growth in assets has remained far behind that of conventional rural banks
- Lack of popular demand for Islamic banking services, absentee ownership, lack of young dynamic management, lack of mastery of overly complex Islamic banking practices, and emphasis on the informal sector and the poor to the neglect of more profitable market segments are among the many reasons for their retarded development

6. Islamic cooperatives (BMT)

Overview: Islamic cooperatives suffer from the same benign regulatory neglect as conventional cooperatives. There is no overall supervision and no systematic recording of either conventional or Islamic cooperatives (BMT); most BMT (83% according to a BI estimate) are not even registered with the Ministry of Cooperatives. After a period of rapid growth after 1995 when PINBUK assumed their promotion, they are now in decline; the majority of the 3000 BMT now are assumed to be dormant or technically bankrupt. PINBUK has no power to enforce reporting, much less so prudential regulation; the Ministry has the power, but does not use it, and may in fact be an inappropriate organization to do so. All general information provided in this report on cooperatives is therefore of questionable validity. In recent years, efforts have been made to improve the quality of cooperatives, reportedly with initial success in some areas like Central Java.

There are around 2,900 BMT, constituting 7.2% of all financial cooperatives, 2.9% of their deposits and 1.1% of loans outstanding. Borrower outreach is reported as 73,000 accounts, which is less than 1% of the total borrower outreach of the financial cooperative sector. There is no information on the number of deposit accounts.

Regional distribution: The majority of the 2,900 BMT are located on Java (60% in 2003), but they are spread far more equally over western, central and eastern Java. 20% are on Sumatra, and 12% on Sulawesi. BMT are underrepresented on Kalimantan and the smaller islands.

Mission, legal status, governance and supervision: The BMT in our sample see it as their mission to help the enterprising poor, particularly very small micro-entrepreneurs including food vendors. Only an estimated 500 out of the 3,000 BMT are registered as financial cooperatives with the MoC. It is not expected that the draft Microfinance Law of 2001, which might have provided a legal framework, will be enacted within the foreseeable future. As cooperatives, BMT are owned by their members; but there is frequently a distinction between shareholding voting and associated members. Board size and composition are not standardized. Only about 50% report to PINBUK, which has no formal supervisory powers; a supervision project was short-lived as funds ran out. INKOPSYAH receives monthly reports from its members as a prerequisite for access to sources of refinancing. Officials from the MoC rarely get involved beyond attending annual meetings when invited. There is no external auditing. Supervisory arrangements, enforcement of standards, information and reporting are either absent or ineffective.

Delivery system, market and outreach: The four sample BMT have on average around four staff members, with an average service radius of about 14 km. BMT do not normally have branches. The majority of clients are small and itinerant traders and other micro-entrepreneurs. There is no reliable information on outreach. We estimate total saver and borrower outreach at around 1.7 million, but probably only about a third of them are active.

Total assets and sources of funds: The median asset size per BMT is estimated by PINBUK at Rp 250 million (US$ 24,000) as of 2001. 2% were listed with asset sizes above Rp 1 billion, 9.5% with asset sizes below 50 million. Deposits are the main source of funds, followed by capital. In contrast to conventional cooperatives, borrowings in BMT seem to be of minor importance; the mean loan portfolio is almost matched by deposits (LDR = 103%).

Financial services: The question about the difference between Islamic and comparable non-Islamic institutions evoked little response. Deposit products are mainly based on *Mudarabah*, ie, revenue-sharing between clients and BMT. The average ratio in the four sample BMT for savings accounts is 34:66, average annual returns are 8.8%; the respective values for term deposits are 42:58 and 13.6% – not significantly higher than in the sample BPRS.

The average number of loan accounts in the four sample BMT, which are far above the national average in size, is 327. Loan sizes are less than half the volume of those in the sample BPRS. In the sample BMT, 61.5% of financing is *Murabahah*, which is less than in the BPRS. *Mudarabah* has a share of 32.0%, and *Qard Hasan* at 3.5%, are relatively more important than in the BPRS. Requiring collateral is standard. In some cases there is compulsory saving of around 5%. Effective annual mark-ups, or profit margins to the bank,

are around 50%. It is common not to charge penalties on late payments. Given a sample size of 4 out of 2900, all these figures may not even be indicative.

Economic performance: In the absence of effective regulation and supervision, the performance of BMT is very uneven; information is sporadic. A large number of BMT are dormant. PNM has identified 500 BMT, which are members of INKOPSYAH and registered with the MoC, as worth strengthening; this is less than one-fifth of the total number. In the four sample BMT, NPF ratios vary widely, from 1.4% to 30%, but are mostly estimates. All four BMT in our sample show positive returns on year-end assets, with ROAs ranging from 0.16% to 2.7%; but sizeable bad debts may not have been written off.

Affiliations and support: The most important promoter of Islamic cooperatives is PINBUK, established in 1995. It provides BMT with an MIS and, through regional offices, basic, intermediate and advanced training, plus training of trainers. INDOPSYAH, a commercially operating second-level cooperative, functions as a wholesaler of funds from other sources. Microfin has established a network of 109 BMT and channels project funds to a total of 673 BMT and *Kopontren*, plus 24 BPRS; it also tries to promote their institutional upgrading to MFIs (LKM) or BPRS. PNM, which has replaced Bank Indonesia's liquidity credit operations, has provided liquidity to 85 BMT. To step up its outreach and effectiveness, it will cooperate with PINBUK and ASBISINDO to provide supervision and human resource development services. Additional financial resources are provided by Islamic banks. BMI, the first Islamic bank, channels funds through Baitulmaal Muamalat and technical assistance through the Muamalat Institute for Research, Training, Consulting & Publication. BMTs also receive donations from wealthy Muslims. The main constraints for BMT are management and supervisory weaknesses, not funding.

Concluding assessment: The outreach of Islamic cooperatives is negligible, their overall performance poor, and for several years they have been in decline:

- There is a complete lack of regulation, supervision and reliable reporting.
- The majority of cooperatives are reported to be dormant or technically bankrupt.
- Their outreach is negligible, accounting for 7.2% of all financial cooperatives, but less than 1% of the borrower outreach of the sector.
- Their loan portfolio (much of it overdue) accounts for just 1.10% of the financial cooperative sector and 0.19% of the microfinance sector.
- The savings of depositors are at great risk.

Comparing Islamic with conventional financial cooperatives, we can conclude that:

- The whole cooperative sector has historically suffered from a lack of regulation and supervision, paralleled by excessive government interference and subsidies which have distorted rural financial markets and undermined self-help.
- The majority of Islamic cooperatives are reportedly dormant or technically bankrupt.
- Their outreach is negligible compared to conventional cooperatives, which are also in a state of acute but undiagnosed ill-health.

- The savings of depositors are at great risk; cooperatives should not be authorized to accept savings of non-members.
- Overall, no remedy is in sight.

7. Conclusions

Islamic finance, after 13 years, accounts for a mere 0.74% of the total assets of the banking sector. However, since Bank Indonesia officially recognized a dual banking system, enthusiasm for Islamic finance has spread among commercial banks, fuelled by low rates of NPL, and the share of Islamic commercial banks more than quadrupled during the last three years, 2001-2003: from 0.17% to 0.74%.

Islamic rural banks (BPRS), providers of microfinance services, are under the same effective prudential regulation and supervision as commercial banks and conventional rural banks (BPR). After a promising start in the early 1990s, their development has almost come to a standstill. Despite the fact that they have had only two years less than conventional BPR, which started to evolve after the rural banking act of 1988, and despite the special services provided by the Islamic Banking Directorate of Bank Indonesia, they have attained a mere 4.0% of the number and 1.5% of the assets of the rural banking sector; and their growth in recent years has been much slower than that of the conventional rural banks:

- The number of BPRS grew by 6.5, conventional BPR by 137 banks p.a.
- Average assets of BPRS amount to only 38% of the assets of conventional BPR.
- During 2001-2003, total assets of BPRS grew by 70%, compared to 173% in the BPR sector.

Islamic financial cooperatives have suffered from the same regulatory and supervisory neglect as the rest of the sector. After a period of rapid growth during most of the 1990s, they are now in decline, with perhaps no more than a fifth expanding and in good health. Fresh money pumped into the BMT sector without effective regulation and supervision including mandatory auditing will further contribute to their downfall, as has been the case in the state-supported KSP/USP sector.

8. Recommendations

We recommend that decision-makers in Islamic organizations, government agencies and donor organizations should cautiously examine the following opportunities for the development of a healthy Islamic financial sector in Indonesia:

1. **Islamic commercial banks,** in setting up branch networks of Islamic MFIs, may learn, with good prospects, from the rich experience of successful microfinance strategies and institutions within Indonesia, particularly the BRI Microbanking Division, one of the most successful microfinance programs in the developing world.

2. **Islamic rural banks** need to be revamped if they are to play a more than marginal role in Indonesia. This will require an overall development plan for the BPRS sector mutually agreed upon by all stakeholders and a strong banking association to provide a full range of support services to their members. Some of the more successful Islamic rural banks may serve as exposure training sites to future managers. Auditing should be mandatory regardless of size.

3. **Islamic cooperatives** suffer from much the same set of problems as the whole cooperative sector. There is little chance for any intervention to be successful in the short run. Cooperatives need a system of prudential regulation, mandatory auditing, and effective supervision by an appropriate financial authority. They should be fully financed through equity and savings deposits of members; only healthy and well-supervised cooperatives should be permitted to collect deposits from non-members. They need strong associations and federations to provide a full range of support services to their members.

9. Postscript: Islamic finance in the province of Aceh after the Tsunami

Of all the areas devastated by the Tsunami of 26 December 2004, the province of Aceh was the hardest hit. Providing relief and reconstructing the livelihoods of the surviving victims is the immediate task; reconstructing the physical and institutional infrastructure will have to come next. If reconstruction efforts are to lead to sustainable development, rural finance and microfinance will have an important role to play. The people of Aceh adhere strongly to the principles of Islam, including those of Islamic finance; taking or charging interest (*Riba*) is against their religious convictions. Building strong Islamic financial institutions in Aceh could be of enormous benefit to the reconstruction and development of the province, and Aceh could benefit the most of all Indonesia's provinces from the results of this study.

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Annex 1: Contacts

Organizations and persons met	Contact addresses
ASBISINDO Asosiasi Bank Syariah Indonesia Wahyu Dwi Agung, Head	BI Gd. Kebon Sirih 5th 2310108 ext. 4511 asbisindo@telkom.net
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Ministry of Cooperatives and Small Enterprises: Bidang Pengembangan dan Pengendalian Kelompok Simpan Pinjam (KSP): Rismanto BS, Head	 Jl. HR Rasuna Said Kav. 3-5 52992757, 0811885744
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PINBUK Pusat Inkubasi Bisnis Kecil – Center for Microenterprise Incubation (*actually for BMT training*) Aslichan Burhan, General Manager	0815 880 2555 abee@telkom.net

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Annex 2:
Questionnaire:
Islamic microfinance institutions in Indonesia

Name of institution:	
Locality:	
District:	
Province:	
Tel.:	
Fax:	
Contact person:	
Email :	

1. General data

a. Type of institution and legal status:
1 BPRS
2 BMT
3 Other: ______________

b. Year of establishment: ___________

c. Mandate:

d. History, restructuring, major changes:

2. Ownership and governance

a. Ownership

b. Board

c. Management:
Autonomy of management
Lending limits

Controversial issues between management and board

d. Internal control

e. External auditing and supervision

Date of last audit _________

f. Network affiliations

g. Affiliations with religious institutions

h. Assessment of differences from similar non-Islamic institutions

3. Delivery system

3. Delivery system	
Number of branches and other units (including head office)	
Number of staff	
Number of loan officers	
Service radius (km to furthest customer)	

a. Lending authority of:
Board
Head-office
Branches and sub-branches

b. Do branches and sub-branches function as profit centers?

c. Staff:
Professional qualifications

Performance incentive scheme

4. Market

4. Market	
Describe target population	
Total number of clients:	
Percent farmers	
Percent micro-entrepreneurs	
Percent salaried	
Percent women	
Percent below poverty line	
Marketing of financial services (as Islamic finance?)	

5. Financial services

5.1 Financial services	
Number of loan products	
Number of savings products	
Number of other financial products	
Loan portfolio: amount outstanding in million Rp	
Number of loan accounts	
Number of active borrowers (if available)	
Average loan size	
Average loan processing time	
Savings portfolio: amount in million Rp	
Number of savings accounts	
Number of savers (if available)	
Average savings balance	

5.2. **(Islamic) Loan products**

(Specify borrower category: a. individuals without group guarantees, b. individuals guaranteed by solidarity groups, c. groups as financial intermediaries, d. NGOs, e. other: _______)

5.2 Loan products	**L o a n p r o d u c t s**			
	1:	**2:**	**3:**	**4:**
Borrower category a-e				
Minimum loan size				
Maximum loan size				
Profit-sharing margins:	-	-	-	-
Nominal (flat? declining?)				
Fees if any				
Other				
Effective p.a.				
Policy aspects of profit-sharing vs. interest rates				
Penalties for late payment				
Minimum loan period				
Maximum loan period				
Installment schedule				
Collateral/guarantee requirements				
Loan size tied to savings?				
Assessment of projects, credit-worthiness examination				
Loan/project monitoring				

1: ______________________________

2: ______________________________

3: ______________________________

4: ______________________________

5.3. **(Islamic) Savings products**

5.3. Savings products	**Savings products**			
	1:	**2:**	**3:**	**4:**
Compulsory?				
Fixed term?				
Withdrawable?				
Interest (or substitute) rate p.a.				
Observations:				

1: ______________________________

2: ______________________________

3: ______________________________

4: ______________________________

5.4 **Other financial products**

5.5 **Non-financial services** (if any)

6. Economic performance

a. Overview of economic performance:

b. Main sources of funds

c. Average costs of funds

d. Loan recovery:
Policy, relevance, importance, enforcement, actual performance

e. What measures have been introduced to improve efficiency?

Balance sheet, 31 December 2002 and 2003

Amounts in Rp million

6.1. Balance sheet	2002	2003	
Cash at hand Kas			
Bank deposits Giro, tabungan, deposito pada bank			
Gross loans/facilities outstanding Pembiayaan yang diberikan kotor			
./. Loan loss reserve ./. Penyisihan Penghapusan	( )	( )	( )
=Net loans/facilities outstanding = Pembiayaan yg diberikan bersih			
Net fixed assets Aktiva tetap setelah dikurangi			
Unpaid taxes Hutang pajak			
Other net assets Aktiva lain-lain Bersih			
Total assets **Jumlah aktiva**			
Savings and deposits of clients Simpanan			
Deposits of banks Simpanan dari bank lain			
Borrowing Pinjaman			
Other liabilities Kewajiban lain-lain			
Total liabilities **Jumlah kewajiban**			
Paid-up capital Modal ditempatkan dan disetor penuh			
Retained earnings (of previous years) Laba tahun lalu			
Profit of current year Laba tahun berjalan			
Total equity **Jumlah ekuitas**			
Total liabilities and equity **Jumlah kewajiban dan ekuitas**			

Income statement, 31 December 2003

Amounts in Rp million

6.2. Income statement	
Gross income from financial operations *Pendapatan marjin, bagi hasil, provisi, komisi*	
./. Interest or profit-sharing expenses *./. Beban marjin dan bagi hasil*	
= Net income from financial operations *= Jumlah pendapatan marjin dan bagi hasil*	
+ Other operational income *+ Jumlah pendapatan operasional lainnya*	
./. Other operational expenses *./. Jumlah beban operasional lainnya*	
Personnel expenses in % *Beban personalia di %*	
Loan loss provisions (included above) *Penyusutan dan penyisihan (di dalam)*	
= Operational profit *= Laba operasional*	
./. Non-operational expenses *./. Beban non-operasional*	
= Gross profit (loss) *= Jumlah laba (rugi)*	
./. Religious tax *./. Zakat*	
./. Other expenses *./. Beban pajak penghasilan*	
Net profit (loss) *Laba bersih (rugi)*	

6.3. Performance	2001	2002	2003
Loan recovery			
NPL, NPF in %			
Loans written off in million Rp			
Loan loss ratio in %			
Profitability			
Return on average assets in %			
Return on average equity in %			
Ratios			
Equity/liabilities in %			
Deposits/liabilities in %			
LDR loan-to-deposit, FDR financing-to-deposit ratio in %			
CAR capital adequacy in %			
Efficiency			
Number of active borrowers per loan officers			
OCR BOPO Operational costs-to-revenue			
Value of loans outstanding per loan officer			

NPL, NPF non-performing loans; Islamic: non-performing finance
Capital adequacy = capital/net loans or net financing
Loan loss ratio = loans written off to average loans outstanding

Annex 3: Balance Sheet & Income Statement of Consolidated balance sheet and income statements of BPRS, 2003

No	ITEMS	Jumlah Jabotabek	Jumlah Wil. KBI	TOTAL NERACA NASIONAL
1	Kas	1,218,686	2,438,758	3,657,444
2	Sertifikat Bank Indonesia	-	-	-
3	Antarbank Aktiva	9,128,753	22,760,482	31,889,235
4	Kredit Yang Diberikan	50,453,310	88,107,877	138,561,187
5	Penyisihan Aktiva Produktif (-/-)	(1,189.702)	(3,270,066)	(4,459,768)
6	Aktiva Dalam Valuta Asing	-	-	-
7	Aktiva Tetap dan Inventaris	2,045,709	6,825,872	8,871,581
	a. Tanah dan Gedung	811,433	2,968,067	3,779,500
	b. Akumulasi Penyusutan Gedung (-/-)	(40,961)	(203,929)	(244,890)
	c. Inventaris	2,567,268	6,933,812	9,501,080
	d. Akumulasi Penyusutan Inventaris (-/-)	(1,292,031)	(2,872,078)	(4,164,109)
8	Antarkantor Aktiva	-	-	-
9	Rupa-rupa Aktiva	2,239,035	10,991,650	13,230,685
	Jumlah Aktiva	63,895,791	127,854,573	191,750,364
1	Kewajiban yg. Segera Dibayar	397,434	1,293,485	1,690,919
2	Tabungan	17,638,210	40,935,885	58,574,095
3	Deposito Berjangka	22,093,054	29,331,737	51,424,791
4	Bank Indonesia	650,000	517,900	1,167,900
5	Antarbank Pasiva	8,564,800	12,350,535	20,915,335
6	Pinjaman Diterima	1,339,206	5,898,703	7,237,909
	a. Pinjaman Subordinasi	3,100	-	3,100
	b. Lainnya	1,336,106	5,898,703	7,234,809
	i Sampai Dengan 3 Bulan	227,222	-	227,222
	ii Lebih Dari 3 Bulan	1,108,884	5,898,703	7,007,587
7	Antarkantor Pasiva	-	-	-
8	Rupa-rupa Pasiva	909,029	5,844,904	6,753,933
9	Modal	11,539,936	26,050,883	37,590,819
	a. Modal Dasar	13,213,000	38,237,000	51,450,000
	b. Modal yg. Blm. Disetor (-/-)	(4,595,760)	(15,849,900)	(20,445,660)
	c. Modal Sumbangan	851,188	292,601	1,143,789
	d. Modal Pinjaman	2,071,508	3,371,182	5,442,690
10	Cadangan	816,678	2,898,292	3,714,970
	a. Cadangan Umum	563,346	1,527,447	2,090,793
	b. Cadangan Tujuan	177,196	710,563	887,759
	c. Laba Yang Ditahan	76,136	660,282	736,418
11	Laba/Rugi	(52,556)	2,732,249	2,679,693
	a. Tahun Lalu	(453,972)	1,889,516	1,435,544
	i Laba Tahun Lalu	1,593,485	4,457,001	6,050,486
	ii Rugi Tahun Lalu (-/-)	(2,047,457)	(2,567,485)	(4,614,942)
	b. Tahun Berjalan	401,416	842,733	1,244,149
	i Laba Tahun Berjalan	493,226	1,047,077	1,540,303
	ii Rugi Tahun berjalan (-/-)	(91,810)	(204,344)	(296,154)
	Jumlah Pasiva	63,895,791	127,854,573	191,750,364
	Modal	12,304,058	31,681,424	3,985,482
	aktiva produktif	50,453,310	88,107,877	138,561,187
		24.39%	35.96%	31.74%
	ROA (current year)	0.63%	0.66%	0.65%
	ROE (current year)	3.48%	3.23%	3.31%
	PPAP/AP	2,36%	3,71%	3,22%

Annex 4: List of BPRS (June 2004)

No.	Legal body	Name of BPRS	Date of license	Date of operation	Kab/Kotamadya/ City	Propinsi/ Province
1	PT (Ltd.)	**Ibadurrahman**	Sep 93	Oct 93	Penajam Paser Utama	Kalimantan Timur
2	PT (Ltd.)	**Hareukat**	Oct 91	Nov 91	Aceh Besar	Nanggroe Aceh Darussalam
3	PT (Ltd.)	**Baiturrahman**	Mar 94	Apr 94	Aceh Besar	Nanggroe Aceh Darussalam
4	PT (Ltd.)	**Tengku Chiek Dipante**	Mar 94	Apr 94	Pidie	Nanggroe Aceh Darussalam
5	PT (Ltd.)	**Hikmah Wakilah**	Jul 95	Jul 95	Banda Aceh	Nanggroe Aceh Darussalam
6	PT (Ltd.)	**Sakai Sambayan**	Jan 96	Feb 96	Lampung Selatan	Lampung
7	PT (Ltd.)	**Daya Murni Sejahtera**	Mar 97	Apr 97	Tulang Bawang	Lampung
8	PT (Ltd.)	**Berkah Amal Sejahtera**	Jul 91	Jul 91	Bandung	Jawa Barat
9	PT (Ltd.)	**Dana Mardhatilla**	Jul 91	Jul 91	Bandung	Jawa Barat
10	PT (Ltd.)	**Amanah Rabbaniah**	Sep 91	Oct 91	Bandung	Jawa Barat
11	PT (Ltd.)	**Mentari**	Jan 93	Feb 93	Garut	Jawa Barat
12	PT (Ltd.)	**Baitur Ridha**	Jun 93	Sep 93	Bandung	Jawa Barat
13	PT (Ltd.)	**Babusaalam**	Nov 93	Nov 93	Bandung	Jawa Barat
14	PT (Ltd.)	**Dana Tijarah**	Dec 93	Jan 94	Cimahi	Jawa Barat
15	PT (Ltd.)	**Mukarramah**	Mar 94	Mar 94	Bandung	Jawa Barat
16	PT (Ltd.)	**Al Ma'soem Syari'ah**	May 94	Jul 94	Bandung	Jawa Barat
17	PT (Ltd.)	**Harum Hikmah Nugraha**	Jun 94	Jul 94	Garut	Jawa Barat
18	PT (Ltd.)	**Artha Sakinah**	Aug 94	Aug 94	Cianjur	Jawa Barat
19	PT (Ltd.)	**Ishlalul Ummah**	Sep 94	Feb 94	Cimahi	Jawa Barat
20	PT (Ltd.)	**Artha Fisabilillah**	Apr 95	Jun 95	Cianjur	Jawa Barat
21	PT (Ltd.)	**Tolong Menolong Bermanfaat (To'at) Baleendah**	Jan 96	Mar 96	Bandung	Jawa Barat
22	Koperasi (Cooperation)	**Al Ihsan**	May 95	Jun 95	Bandung	Jawa Barat
23	PT (Ltd.)	**Berkah Gemadana**	Sep 93	Oct 95	Banjar	Kalimantan Selatan
24	PT (Ltd.)	**Muamalat Harkat**	Jan 96	Jan 96	Bengkulu Selatan	Bengkulu
25	PT (Ltd.)	**Syarif Hidayatullah**	Feb 94	Mar 94	Cirebon	Jawa Barat
26	PT (Ltd.)	**Syariat Fajar Sejahtera Bali**	Apr 94	May 94	Badung	Bali
27	PT (Ltd.)	**Muamalat Yofeta**	Feb 98	Mar 98	Jayapura	Papua
28	PT (Ltd.)	**Artha Sinar Mentari**	Jul 94	Sep 94	Jember	Jawa Timur
29	PT (Ltd.)	**Amanah Ummah**	Jul 92	Jul 92	Bogor	Jawa Barat
30	PT (Ltd.)	**Artha Karimah Irsyadi**	Oct 92	Nov 92	Bekasi	Jawa Barat
31	PT (Ltd.)	**Bina Amwalul Hasanah**	Dec 92	Feb 93	Depok	Jawa Barat
32	PT (Ltd.)	**Inti Raqqat**	Dec 92	Dec 92	Tangerang	Banten
33	PT (Ltd.)	**Harta Insan Karimah**	Aug 93	Sep 93	Tangerang	Banten
34	PT (Ltd.)	**Baituniaga Insani**	Oct 93	Oct 93	Bekasi	Jawa Barat
35	PT (Ltd.)	**Saleh Artha**	Dec 93	Jan 94	Bekasi	Jawa Barat
36	PT (Ltd.)	**Tijari Baitul Maal**	Apr 02	Apr 02	Tangerang	Banten
37	PT (Ltd.)	**Baitul Muawanah**	Aug 94	Sep 94	Cilegon	Banten
38	PT (Ltd.)	**Attaqwa Garuda Utama**	Oct 94	Oct 94	Tangerang	Banten
39	PT (Ltd.)	**Wakalumi**	Jan 95	Apr 95	Tangerang	Banten
40	PT (Ltd.)	**Darma Amanah**	May 95	Jun 95	Lebak	Banten
41	PT (Ltd.)	**Al Barokah**	Jan 96	Mar 96	Depok	Jawa Barat
42	PT (Ltd.)	**Risalah Ummat**	Mar 96	May 96	Tangerang	Banten
43	PT (Ltd.)	**Bina Rahmah**	Sep 96	Oct 96	Bogor	Jawa Barat
44	PT (Ltd.)	**Insani**	Oct 96	Oct 96	Tangerang	Banten
45	PT (Ltd.)	**Ariyah Jaya**	Oct 96	Oct 96	Depok	Jawa Barat
46	PT (Ltd.)	**Amanah Insani**	Oct 97	Oct 97	Bekasi	Jawa Barat
47	PT (Ltd.)	**Rif'atul Ummah**	Feb 98	May 98	Bogor	Jawa Barat
48	PT (Ltd.)	**Insan Cita Artha Jaya**	Feb 98	Feb 98	Bogor	Jawa Barat

49	PT (Ltd.)	**Berkah Ramadhan**	Mar 02	Apr 02	Tangerang	Banten
50	PT (Ltd.)	**Al Mabrur Babadan**	Nov 00	Jan 01	Ponorogo	Jawa Timur
51	PT (Ltd.)	**Rahman Hijrah Agung**	Dec 95	Dec 95	Aceh Utara	Nanggroe Aceh Darussalam
52	PT (Ltd.)	**Bhakti Haji Malang**	Dec 95	Mar 96	Malang	Jawa Timur
53	PT (Ltd.)	**Daya Artha Mentari**	Mar 96	Mar 96	Pasuruan	Jawa Timur
54	PT (Ltd.)	**Al Hidayah**	May 99	Jun 99	Pasuruan	Jawa Timur
55	Koperasi (Cooperation)	**Untung Surapati**	Aug 01	Sep 01	Pasuruan	Jawa Timur
56	PT (Ltd.)	**Tulen Amanah**	Mar 93	Mar 93	Lombok Timur	Nusa Tenggara Barat
57	PT (Ltd.)	**Patuh Beramal**	Feb 94	Feb 94	Mataram	Nusa Tenggara Barat
58	PT (Ltd.)	**Kafalatuh Ummah**	Jun 94	Jul 94	Deli Serdang	Sumatera Utara
59	PT (Ltd.)	**Al Washliyah**	Sep 94	Nov 94	Deli Serdang	Sumatera Utara
60	PT (Ltd.)	**Gebu Prima**	Feb 96	Mar 96	Medan	Sumatera Utara
61	PT (Ltd.)	**Puduarta Insani**	Apr 96	Jun 96	Deli Serdang	Sumatera Utara
62	PT (Ltd.)	**Mentari Pasaman Saiyo**	May 96	Jul 96	Pasaman	Sumatera Barat
63	PT (Ltd.)	**Carana Kiat Andalas**	May 97	Jun 97	Agam	Sumatera Barat
64	PT (Ltd.)	**Ampek Angkek Candung**	May 99	Jul 99	Agam	Sumatera Barat
65	PT (Ltd.)	**Al Falah**	Dec 94	Jan 95	Musi Banyuasin	Sumatera Selatan
66	PT (Ltd.)	**Hasanah**	Jan 95	Apr 95	Bengkalis	Riau
67	PT (Ltd.)	**Berkah Dana Fadhilah**	Jun 96	Jun 96	Kampar	Riau
68	PT (Ltd.)	**Amanah Bangsa**	Jul 94	Sep 94	Simalungun	Sumatera Utara
69	PT (Ltd.)	**Sabiilul Muttaqiin**	Oct 96	Jan 97	Banyumas	Jawa Tengah
70	PT (Ltd.)	**Ikhsanul Amal**	Aug 95	Aug 95	Kebumen	Jawa Tengah
71	PT (Ltd.)	**Asad Alif**	Aug 98	Sep 98	Kendal	Jawa Tengah
72	PT (Ltd.)	**Bakti Makmur Indah**	Feb 94	Apr 94	Sidoarjo	Jawa Timur
73	PT (Ltd.)	**Amanah Sejahtera**	Dec 95	Jan 96	Gresik	Jawa Timur
74	PT (Ltd.)	**Al Wadi'ah**	Sep 94	Dec 94	Tasikmalaya	Jawa Barat
75	PT (Ltd.)	**Ikhwanul Ummah**	Apr 93	Apr 93	Ujung Pandang	Sulawesi Selatan
76	PT (Ltd.)	**Matahari Ufuk Timur**	Jun 94	Jun 94	Maros	Sulawesi Selatan
77	PT (Ltd.)	**Sinar Surya Sejati Palleko**	Jul 94	Aug 94	Takalar	Sulawesi Selatan
78	PT (Ltd.)	**Niaga Madani**	Oct 94	Dec 94	Pinrang	Sulawesi Selatan
79	PT (Ltd.)	**Nurul Ikhwan**	Jun 95	Jun 95	Polewah Mamasa	Sulawesi Selatan
80	PT (Ltd.)	**Gowata**	Sep 97	Dec 97	Gowa	Sulawesi Selatan
81	PT (Ltd.)	**Margirizki Bahagia**	Nov 93	Jan 94	Bantul	Yogyakarta
82	PT (Ltd.)	**Bangun Drajat Warga**	Nov 93	Feb 94	Bantul	Yogyakarta
83	PT (Ltd.)	**Ittihad**	Apr 02	Jun 02	Wajo	Sulawesi Selatan
84	PT (Ltd.)	**Bumi Rinjani Batu**	Nov 02	Jan 03	Batu	Jawa Timur
85	PT (Ltd.)	**Bumi Rinjani Malang**	Nov 02	Jan 03	Malang	Jawa Timur
86	PT (Ltd.)	**Cilegon Mandiri**	Apr 03	May 03	Cilegon	Banten
87	PT (Ltd.)	**Buana Mitra Perwira**	Jun 04	Jun 04	Purbalingga	Jawa Tengah
88	PD (Local Govt. Co.)	**Tanggamus**	May 04	Jun 04	Tanggamus	Lampung
89	PT (Ltd.)	**Artha Surya Barokah**	Jun 04		Semarang	Jawa Tengah
90	PT (Ltd.)	**Situbondo**	Mar 04		Situbondo	Jawa Timur

Appendix 1: Financial infrastructure

Indonesia has one of the most differentiated banking and microfinance sectors of any developing country. After more than 100 years of evolutionary growth, the banking sector as of 2003 comprised:

- 138 commercial banks, with a total of 7,730 bank offices if 4,049 BRI rural units are excluded, and 11,779 if they are included
- 2,134 BPR, comprising rural and peri-urban banks.

The rural and microfinance sector comprises (see Table 1)[37]:

- 6,300 formal microfinance units
- 47,200 semiformal microfinance units
- Together, these 53,500 units hold 47 million deposit and 32 million loan accounts
- 800,000 channeling groups
- millions of rotating savings and credit associations (ROSCAs, arisan) of indigenous origin.

After the establishment of the first rural bank in 1895, a three-tier financial system rapidly developed, comprising national, district and village institutions. At the top was a century-old agricultural bank, now known as Bank Rakyat Indonesia (BRI). At the community level there were two types of village banks, specialized in banking-in-kind and banking-in-money. As early as 1910, there were over 13,000 rural banks, comprising 12,542 rice banks (*Lumbung Desa*) and 585 money banks (*Bank Desa*). Since then, money has gradually replaced kind: as of 1940, their numbers had changed to 5,451 *Lumbung Desa* and 7,443 Bank Desa. As of 1989 there were 2,056 *Lumbung Desa* and 3,297 *Bank Desa*, and these have since been lumped together.[38] According to a recent ADB study[39], the microfinance sector now comprises some 6,000 formal and 48,000 semiformal MFIs, serving about 45 million depositors[40] and around 32 million borrowers (see Table 1).[41] Among them, the BRI Units (formerly *Unit Desa*) – which are arguably the developing world's most successful rural microfinance providers – account for 74% of micro-savings and 39% of micro-loans. Finally, outside the formal and semiformal institutional sector are

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37 These institutions are predominantly rural and peri-urban. The figures differ widely according to the source used. For example, Holloh (2001: 33) lists a total of 93,700 outlets. A number of institutions with outreach into rural microfinance are not included here, among them private national and regional commercial banks and regional government-owned development banks (BPD).

38 Steinwand (2001: 172); Holloh 2001; H. D. Seibel, Finance with the Poor, by the Poor, for the Poor: Financial Technologies for the Informal Sector, with Case Studies from Indonesia. Social Strategies Vol. 3, No. 2 (Dec. 1989): 3-47.

39 ADB Rural Microfinance Indonesia (TA No. 3810-INO), March 2003, Annex 4.

40 This figure records the number of deposit accounts, the number of actual depositors is lower.

41 These institutions are predominantly rural and peri-urban. The figures differ widely according to the source used. Holloh (2001:33), for example, lists a total of 93,700 outlets. A number of institutions with a partial outreach into rural microfinance are not included here, among them private national and regional commercial banks and regional government-owned development banks (BPD).

some 800,000 channeling groups, as well as the ubiquitous ROSCAs, numbered in the millions, which are the grassroots institutions for most of the poor and non-poor. Renewed efforts have been made to extend the protection of the law to financial institutions of the poor and near-poor with the preparation in 2001 of a draft law for MFIs, the LKM *(Lembaga Keuangan Mikro)*.[42] However, despite the extraordinarily high level of institutional differentiation, large numbers of households are reported to remain without access to formal and semiformal finance.

Table 1: Number and outreach of formal and semiformal MFIs (BRI, BPR and BKD December 2003, others ~2000) (amounts in billion Rp)

	Units* **	**Deposit accounts**		**Deposit volume**		**Loan accounts**		**Loans outstanding**		
		In '000	*%*	*bn Rp*	*%*	*In '000*	*%*	*bn Rp*	*%*	*Av. loan Rp*
Banks										
BRI Microbanking Div.	4,049	29,859	64	27,420	80	3,100	10	14,183	54	4,575,000
Rural banks BPR ~2000	2,213	4,698	10	5,066	15	1,745	5	5,628	21	3,225,000
Rural banks Dec. 2003**	2,134	5,535		8,868		1,993		8,985		4,508,000
Financial cooperatives*	**40,527**	**11,043**	**24**	**1,659**	**5**	**11,093**	**34**	**4,787**	**18**	**431,500**
Unit Simpan Pinjam (USP) ****	35,218	10,141	23	1,157	4	10,141	31	3,629	18	358
Koperasi Simpan Pinjam (KSP, Sav&Cr. Coop)****	1,123	551	1	151	1	551	2	708	4	1,285
Credit unions (CU)	1,071	296	Nil	249	1	296	1	272	1	920
BMT	2,938		Nil	46	Nil	73	0	51	0	701
Swamitra/BUKOPIN	177	55	Nil	56	Nil	32	0	127	1	3,960
Non-bank financial institutions										
Village MFIs (BKD)	4,482	535	1	24	0	414	1	193	1	466,000
Other MFIs (LDKP)	1,428	834	2	218	1	419	1	328	1	783,000
Pawnshops	772	0	0	0	0	15,692	48	1,355	5	86,000
Total all institutions*	**53,471**	**46,969**	**101**	**34,387**	**101**	**32,463**	**99**	**26,474**	**100**	**815,500**

* Errors in percentage totals due to rounding.

** Figures on BPR on the Bank Indonesia website differ by +/- 2%.

*** The term *units* is not uniformly applied. For example, in the case of the BRI Microbanking Division, it refers to outlets including cash offices of the *unit desa* (now: *unit unit*), whereas in the case of BPR, it refers to banks and excludes their branches.

**** USP and KSP together as of 2003: 40,639.

Sources: BI 2003; BI BPR reporting; BRI Microbanking Division Monthly Report; ADB Rural Microfinance Indonesia (TA No. 3810-INO), Draft report March 2003, Annex 4, p. 2.

The Banking Law in Indonesia recognizes two types of banks: commercial/universal banks (*BU*) and rural banks (BPR).

[42] Act XXX of 2001, draft dated 14/9/2001. This is a participatory effort coordinated by Tim Inisiatif, first headed by Bank Indonesia and now by a newly created microfinance unit in the MoA. The World Bank, ADB and GTZ are involved.

The commercial banking sector, which nearly collapsed during the 1997/98 crisis, has greatly recovered due to major consolidation efforts on the part of the government, including numerous bank closures and mergers. From 1999 to 2003, the gross NPL ratio declined dramatically from 32.8% to 8.1%, and net NPL from 7.3% to 1.8%. During the same period, the banks went from recording losses (Rp 75.4tr, or 7.5% of total assets as of December 1999) to announcing (pre-tax) profits of Rp 23.7tr, or 2.1% of total assets as of November 2003. In similar fashion the overall CAR rose from - 8.1% in 1999 to 20.7% in 2003. However, overall growth in the commercial banking sector was more sluggish: from December 2000 to November 2003, total assets grew in nominal terms by 10.8% from Rp 1,030.5tr to Rp 1,142.2tr; third-party funds (including savings and deposits) by 25.2% from Rp 699,1tr to Rp 875.4tr; and credit by 48.5% from Rp 320.4tr to Rp 475.7tr.

Rural banks (BPR) according to the law of 1988 (*PAKTO27*) consist of newly established BPR (*BPR baru*) and pre-existing rural banks converted into BPR (*BPR lama*). In the context of financial liberalization, the law was enacted in an effort to rationalize the highly complex rural finance sector, with the objective of bringing existing institutions under the umbrella of prudential regulation and supervision, providing a framework for the establishment of new financial institutions with private capital, and extending the outreach of financial institutions to the poorer sections of the rural and peri-urban population, thereby lessening their dependence on private moneylenders. Minimum capital requirements for BPR were uniformly set at Rp 50m, equivalent to US$ 29,000 in 1988, $24,000 in 1992 and $21,000 in 1996. Most of the newly established BPR were set up by private owners.

As of December 2003 there were 2,134 licensed and regulated BPR. While these account for a mere 1.0% of total banking assets, their growth during the last three years has been far more rapid than that of the commercial banking sector (see below).

Table 1.2: Basic data on BPR, 2000-2003 (amounts in trillion Rp)

Year	Number	Total assets	Credit	Savings (tabungan)	Deposits (deposito)	Savings & deposits	Paid-in capital
2000	2,419	4.99	3.78	1.20	1.89	3.09	1.09
2001	2,355	6.75	5.04	1.59	2.71	4.30	1.49
2002	2141	9.34	6.86	2.02	4.12	6.14	1.91
2003	2134	12.90	9.18	2.64	6.25	8.89	2.41

Source: http://www.bi.go.id/bank_indonesia_english/main/statistics/. Figures may differ from reports written by Bank Indonesia (BI), which reflect various stages of updating.

Appendix 2: Development of conventional and Islamic rural banks in Indonesia, 1993-2003

Appendix 2 Table 1: Development of conventional and Islamic rural banks in Indonesia, 1993-2003 Million IDR

	Dec'93	Dec'94	Dec'95	Dec'96	Dec'97	Mar'98	June'98	Sept'98	Dec'98	Dec'99	Dec'00	Dec'01	Dec'02	Dec'03
1. Number of banks														
Total RBs	1709	1873	1948	1987	2140	2186	2227	2262	2262	2427	2419	2355	2141	2134
IRBs	22	46	57	71	75	77	77	78	78	79	80	81	83	84
Share IRBs to Total	1.3	2.5	2.9	3.6	3.5	3.5	3.5	3.4	3.4	3.3	3.3	3.4	3.9	3.9
2.Loans (Million Rp)														
Total RBs	1195868	1476001	1790193	2036205	2172515	2090393	1965230	1875365	1860595	2451593	3618927	5040000	6860000	9180000
IRBs	7380	19952	28737	39008	43330	51780	50500	51246	53502	57306	82326	110026	119206	138561
Share IRBs to Total	0.6	1.4	1.6	1.9	2.0	2.5	2.6	2.7	2.9	2.3	2.3	2.2	1.7	1.5
3. Deposits (Million Rp)														
Total RBs	993264	1207102	1385072	1554250	1576369	1587413	1513163	1489786	1470112	2038132	3081718	4300000	6140000	8890000
IRBs	6118	17654	24226	32513	33160	36061	32905	33683	35550	44067	62512	91417	97512	109999
Share IRBs to Total	0.6	1.5	1.7	2.1	2.1	2.3	2.2	2.3	2.4	2.2	2.0	2.1	1.6	1.2
4. Total assets (Million Rp)														
Total RBs	1566097	1900225	2253478	2574164	2735708	2745066	2696384	2688719	2751415	3462031	4731240	6750000	9340000	12900000
IRBs	11778	30369	43024	50571	60135	73027	70858	73627	80579	86783	113096	153321	165046	191750
Share IRBs to Total	0.8	1.6	1.9	2.0	2.2	2.7	2.6	2.7	2.9	2.5	2.4	2.3	1.8	1.5

* Number of BPRS by Dec. 2001: 4; Dec. 2002: 9

Note: **Double-click** on table to show column Dec'03 on screen

Appendix 2 Table 2: Development of Islamic Rural Banks, 1993-2003 Million IDR

	Dec'93	Dec'94	Dec'95	Dec'96	Dec'97	Dec'98	Dec'99	Dec'00	Dec'01	Dec'02	Dec'03
Financing	7380	19952	28737	39008	43330	53502	57306	82326	110026	119206	138561
Deposits	6118	17654	24226	32513	33160	35550	44067	62512	91417	97512	109999
Total Assets	11778	30369	43024	50571	60135	80579	86783	113096	153321	165046	191750
Number of Banks	22	46	57	71	75	78	79	80	81	83	84

Source: Islamic Banking Directorate-Bank Indonesia

Appendix 3: Evolution and structure of Islamic finance in Indonesia

Table 1: Total assets of commercial and rural banks by conventional and Islamic banking type, 2003 (in trillion Rp)

Banking sector	Conventional		Islamic		Total	
	Amount	*Percent*	*Amount*	*Percent*	*Amount*	*Percent*
Commercial (BU)	1,060.5	98.8	7.86	97.6	1,068.4	98.8
Rural (BPR)	12.7	1.2	0.19	2.4	12.9	1.2
Total banking sector	1,073.2	100.0	8.05	100.0	1,081.3	100.0

Table 2: Basic data on the commercial banking sector and sharia-based commercial banks, December 2003 (amounts in trillion Rp)

Selected consolidated balance sheet items	Total commercial banking sector (amount)	Islamic commercial banks	
		Amount	Percent
Total assets	1068.4	7.86	0.74
Deposits	888.6	5.72	0.64
Loans/financing outstanding	477.2	5.53	1.16
Ratios	*Total commercial banking sector*	*Islamic commercial banks*	
LDR, FDR*	53.7%	96.6 %	
Non-performing loans	8.2%	2.3 %	

Source: BI 1/2004: 13

* Loans-to-deposits ratio, financing-to-deposits ratio

Table 3: Capital adequacy ratios and return on assets in Islamic banks, 2000-2003

	2000	2001	2002	Nov. 2003
CAR of Islamic commercial banks	53.4	30.8	21.5	20.3
CAR of Islamic commercial banking units	23.7	19.9	36.5	32.8
ROA		1.2	0.8	0.6

Source: BI 2003: 128

Table 4: Deposits and loans by Islamic commercial banks and banking units, Dec. 2003

Deposits	
Wadiah current accounts	11.1%
Mudarabah savings accounts	28.1%
Mudarabah time deposits	60.7%
Total percent	99.9%
Total amount	Rp 5.72tr
Percent of total liabilities and equity	72.8%

Table 5: Financing by Islamic commercial banks and banking units, Dec. 2003

Financing	
Musharaka financing	5.5%
Mudarabah financing	14.4%
Murabahah receivables	71.5%
Istishna' receivables	5.4%
Other	3.2%
Total percent	100%
Total amount	Rp 5.53tr
Percent of total assets	70.4%

Appendix 4: Islamic rural banks (BPRS)

Table 1: Regional distribution of BPRS, June 2004

Province	Licensed BPRS		License revoked
	Number	Percent	
Java	53	61.6	4
West Java	25		3
Banten	10		1
Central Java	5		
D.I. Yogyakarta	2		
East Java	11		
Sumatra	20	23.3	
Nangroe Aceh Dar.	5		
North Sumatra	5		
West Sumatra	3		
South Sumatra	1		
Lampung	3		
Bangkulu	1		
Riau	2		
Sulawesi	7	8.1	
South Sulawesi	7		
Kalimantan	2	2.3	
East Kalimantan	1		
South Kalimantan	1		
Bali	1	1.2	
West Nusa Tenggara	2	2.3	
Papua	1	1.2	
Total licensed BPRS	86	100.0	
Revoked licenses			4
Total BPRS			90

Table 2: Year of origin, ownership and number of board members in five sample BPRS

BPRS	Year of origin	No. of owners	Owners	No. of board members
1 Alwadi'ah	1994	3	Private individuals	9
2 Artha Fis.	1994	9	Private individuals	10
3 Harum Hik.	1994	25	3 individuals + 22 employees	7
4 Wakalumi	1990/1994	118	Private individuals	7
5 Bangka	1995	3	2 foundations, local govt.	8

Table 3: Number of delivery units, number of staff and service radius in five sample BPRS

BPRS	Number of units (incl. head office)	Number of staff	Loan officers		Service radius in km
			Number	% of staff	
1 Alwadi'ah	2	18	12		30
2 Artha Fis.	1	11	6		20
3 Harum Hik.	5	22	12		50
4 Wakalumi	5	38	13		40
5 Bangka	2	18	9		50
Average (mean)	3	21.4	10.4	48.6	38

Table 4: Number of borrowers in four sample BPRS

BPRS	Total no. of borrowers
1 Alwadi'ah	*800*
2 Artha Fis.	*163*
3 Harum Hik.	*800*
4 Wakalumi	*2000*
5 Bangka	*664*
Average (mean)	*885*

Table 5: Number of clients by occupation, sex and poverty category in four sample BPRS

BPRS	Total no. of clients	% small traders & micro-entrepreneurs	% farmers	% salaried	% women	% below poverty line
1 Alwadi'ah	*4000*	*89*	*3*	*8*	*30*	*20*
2 Artha Fis.	*1150*	*90*	*1*	*9*	*0*	*0*
3 Harum Hik.	*6000*	*63*	*9*	*23*	*45*	*3*
4 Wakalumi	*5000*	*95*	*0*	*5*	*	*0*
5 Bangka	*1722*	*59*	*2*	*39*	*35*	*3*
Unweighted mean	*3574*	*79*	*3*	*17*	*28*	*5*

* Both husband and wife have to sign the loan contract.

Table 6: Total assets of five sample BPRS

BPRS	Total assets in million Rp
1 Alwadi'ah	6,951
2 Artha Fis.	1,404
3 Harum Hik.	6,887
4 Wakalumi	12,554
5 Bangka	7,689
Average (mean)	7,097
Mean of 84 BPRS	2,283

Table 7: Liabilities and equity of 84 BPRS, December 2003

Source of funds	Amount in million Rp	Percent
Current accounts	1,690.9	0.9
Deposits	109,998.9	57.4
Savings	58,574.1	
Time deposits	51,424.8	
Bank deposits	22,083.2	11.5
Bank Indonesia	1,167.9	
Other banks	20,915.3	
Borrowing	7,237.9	3.8
Subordinated loans	3.1	
Other loans	7.234.8	
Other liabilities	6,753.9	3.5
Equity	43.985.5	22.9
Paid-up capital	31,004.3	
Other capital	6,586.6	
Reserves	3,715.0	
Profit of previous year	1,435.5	
Profit of current year	1,244.1	
Total liabilities and equity	191.750.2*	100.0

*Error due to rounding

Table 8: Deposits of BPRS and BPR as a percentage of total assets and loans outstanding, December 2003

	BPRS	Conventional BPR	BPR
Average deposits in billion Rp	4.17	4.28	4.17
Deposits as a % of total assets	57.4	69.1	68.9
Deposits as a % of loans outstanding	79.4	97.1	96.8

Table 9: Savings and time deposits in the BPRS sector and in five sample BPRS, December 2003

BPRS	Total deposits in million Rp	% savings	% time deposits
1 Alwadi'ah	4,109.0	59.2	40.8
2 Artha Fis.	619.2	75.8	24.2
3 Harum Hik.	4,017.7	34.9	65.1
4 Wakalumi	6,039.9	43.0	57.0
5 Bangka	5,621.5	35.6	64.4
Mean of 84 BPRS	109,998.9	53.2	46.8

Table 10: Deposit products in five sample BPRS

BPRS	Total amount (in million Rp)	Number of products	Savings accounts*		Time deposits*	
			Revenue-sharing Client-Bank	*Average return in % p.a.*	*Revenue-sharing Client-Bank*	*Return in % p.a.*
1 Alwadi'ah	3,796	4	50:50	6%	70:30	10%
2 Artha Fis.	619	4	30:70	12%	40:60	18%
3 Harum Hik.	4,018	3	40:60	8.8%	65:35	14%
4 Wakalumi	6040	12	35:65	7.09	56:44 to 66:34	11.35 to 13.37
5 Bangka	5,622	n.a.	40:60	7.5%	55:45	11.5%
Mean	4,019	5.75	40:60	8.3%	60:50	13%

*By comparison, BMI, an Islamic commercial bank, reports yields to depositors of 6-7% p.a. on savings accounts and 7-9% on term deposits.

Table 11: Loan products in five sample BPRS[43]

BPRS	Amount (in mn Rp)	No. of accounts	No. of products	Loan products in % of portfolio			
				Murabahah	Musyarakah	Mudarabah	Other
1 Alwadi'ah	5,694.4	800	3	60	40		
2 Artha Fis.	1,208.0	163	4	85			15
3 Harum Hik.	4,312.7	800	1	100			
4 Wakalumi	9,652.8	2000	4	93	5	0.5	1
5 Bangka	4,562.8	n.a.	2	90		10	
Unweighted mean	5,086.1	*941*	2,8	86	9	2	3

The five sample BPRS have on average Rp 5.1bn in financing or loans outstanding, with an average of Rp 5.4mn per borrower. They have between one and four loan products. The main product found in every bank is *Murabahah*, i.e. a sales contract between bank and customer with a mutually agreed-upon fixed profit margin for the bank; this accounts for 86% of the unweighted average loan volume. Three of the banks have a *Mudarabah* or a *Musyarakah* product, with profit-sharing between the bank and one or several business partners respectively accounting together for 11% of total financing. Other products are of either minor significance or are completely irrelevant: BPRS Alwadi'ah lists *Qard al-Hasanah* for the very poor among its products, where the bank bears the full risk but receives no remuneration; however, it has in fact no borrowers.[44] BPRS Artha Fisabilillah includes consumer lending to salary earners among its products with a 15% share, which does not fall under the classical Islamic financing products; it also offers *Musyarakah* and *Mudarabah* financing, but its customers have not yet accepted this product. BPRS Wakalumi has a small *Al-Ijarah* or leasing portfolio.

Murabahah, based on the principle of a sales contract with a fixed profit margin for the bank, is the main financing product, with a share of 90-100% in three of the five banks and an overall unweighted share of 86%. With its fixed mark-up (similar to an interest rate), it is better understood by borrowers and contracts are easier to handle for the bank. The mark-ups are generally flat rates, which is common in Indonesia: customers pay a fixed and equal amount per month while repaying in monthly or weekly installments. The effective mark-up per annum varies by installment schedule and maturity; as a rule of thumb, the effective interest rate p.a. is approximately twice the flat rate, assuming equal monthly installments over a repayment period of one year. In addition, there is frequently an upfront administrative fee, mostly around 1%. Of the five sample BPRS, only BPRS Wakalumi charges a mark-up on the declining balance; the others charge flat rates. **Effective annual mark-ups or profit margins** of the five banks are approximately 55% p.a., ranging from a low of 38.5% by the largest to a high of 66% by the smallest of the five banks, assuming average maturities of one year; as actual maturities vary from 6 to 36 months, effective rates can be substantially lower or higher, respectively.[45] There are no penalties for late payment in the five

[43] By comparison, financing of BMI, the oldest and largest Islamic commercial bank with a loan portfolio of Rp. 2.25tr, is distributed product-wise as follows: *Murabahah* 53.5%; *Mudharabah* 34.6% *Musyarakah* 1.6%, and other 10.3%.

[44] BMI also reports the existence of this product, but the amount is insignificant. No mark-up or profit share are included; however, beneficiaries pay an administrative fee of 1%. Maturities are 1-2 years. *Qard* loans are mainly granted to employees, e.g. to rent a house, or for educational and social purposes.

[45] By comparison, BMI charges margins of 15.5% effective p.a. for the first year; 0.5% is added for every additional year (up to 18.5% in the 7th year, the longest period of financing) on *Murabahah* financing.

banks, which means that effective mark-ups or interest rates go down as payments are delayed.[46] By comparison, the interest rates of the BRI units are 2% flat per month or approximately 43% effective p.a. The interest rate is reduced to 1.5% flat per month or 33% effective p.a. for customers who pay on time. BPR are generally less efficient and have higher interest rates than BRI units.

Musyarakah and *Mudarabah* financing tend to be larger in volume: either at the same mark-up as *Murabahan,* as in BPRS Wakalumi, or at almost half the rate, as in BPRS Alwadi'ah.

Loan sizes start as low as Rp 0.5m, 1.0m and 3m (US$ 60-360), respectively, and go up to Rp 50m, 75, 100m or 150m, respectively. Maturities among the five banks are from 1 to 36 months. Installments are mostly monthly; but one bank offers daily installments through a collector, while another permits daily, weekly, monthly or quarterly installments. All loans are collateralized. Two of the five banks require a savings deposit of at least 5%. Loan supervision is reportedly tight, implemented through frequent visits by loan officers or collectors.

Table 12: Non-performing loans, return on average assets and return on year-end assets in five sample BPRS (in %), 2003

BPRS	NPL	ROAA	ROA (yr-end)
1 Alwadi'ah	n.a.	2.0	1.5
2 Artha Fis.	4.5	2.3	2.4
3 Harum Hik.	3.0	n.a.	5.7
4 Wakalumi	11	3.35	2.1
5 Bangka	0	5.0	3.2
BRI units	2.5	5.7	

[46] By comparison, charges no penalties on late payments, but a so-called administrative fee (stated in terms of a nominal amount, approximately 1% of the amount overdue per month), which cannot be claimed as income and is allocated to a social fund.

Table 13: Balance sheet, income statement and performance ratios of BPRS Artha Fisabilillah, 2001-2003

Amounts in million Rp

	Balance sheet	2001	2002	2003
	Activa:			
	Cash at hand Kas	*168*	*118*	*101*
	Gross loans/facilities outstanding Pembiayaan yang diberikan kotor	*910*	*785*	*1,208*
	./. Loan loss reserve ./. Penyisihan Penghapusan	*43*	*65*	*4*
	= Net loans/facilities Outstanding = Pembiayaan yg diberikan bersih	*867*	*720*	*1,204*
	Net fixed assets Aktiva tetap setelah dikurangi	*21*	*19*	*14*
	Other net assets Aktiva lain-lain Bersih	*89*	*106*	*85*
	Total assets **Jumlah aktiva**	***1,145***	***963***	***1,404***
	Passiva:			
	Savings and deposits of clients Simpanan	*619*	*549*	*619*
	Borrowing Pinjaman	*100*	*0*	*338*
	Other liabilities Kewajiban lain-lain	*4*	*0*	*14*
	Total liabilities **Jumlah kewajiban**	***723***	***549***	***971***
	Paid-up capital Modal ditempatkan dan disetor penuh	*387*	*387*	*387*
	Profit of past and current years Laba tahun berjalan	*35*	*27*	*46*
	Total equity **Jumlah ekuitas**	***422***	***414***	***433***
	Total liabilities and equity **Jumlah kewajiban dan ekuitas**	***1,145***	***963***	***1,404***

	Income statement	2001	2002	2003
	Gross income from financial operations *Pendapatan marjin, bagi hasil, provisi, komisi*	466	392	400
	./. Interest or profit-sharing expenses *./. Beban marjin dan bagi hasil*	(116)	(102)	(109)
	= Net income from financial operations *= Jumlah pendapatan marjin dan bagi hasil*	350	290	291
	+ Other operational income *+ Jumlah pendapatan operasional lainnya*	63	44	48
	./. Other operational expenses **./. Jumlah beban operasional lainnya**	(385)	(314)	(305)
	Personnel expenses in % **Beban personalia di %**			
	Loan loss provisions (included above) *Penyusutan dan penyisihan (di dalam)*	137	45	14
	= Operational profit	29*	30	34

	Income statement	2001	2002	2003
	= Laba operasional			
	./. Non-operational expenses *./. Beban non-operasional*	(2)	0	(1)
	= Profit (loss) *= Jumlah laba (rugi)*	27*	30	33*

* Error due to rounding

Performance	2001	2002	2003
Loan recovery			
NPL, NPF in %	9.6	19.8	4.5
Loan loss ratio in %	8.9	18.7	6.25
Profitability			
Return on average assets in %	2.3	1.7	2.4
Return on average equity in %	7.0	4.3	8.75
Ratios			
Equity/liabilities in %	58.4	75.4	44.6
Deposits/liabilities in %	85.6	100.0	63.7
LDR loan-to-deposits, FDR financing-to-deposits ratio in %	147	143	195
CAR Capital adequacy in %	38.7	43.9	31.6

NPL, NPF Non-performing loans; Islamic: Non-performing finance

Loan loss ratio = loans written off to average loans outstanding

Capital adequacy = capital/net loans or net financing

Table 14: Balance sheet, income statement of BPRS Wakalumi, 2002 and 2003

Amounts in million Rp

Balance sheet	2002 (unaudited)	2003 (audited)
Cash at hand Kas	*393.2*	*257.8*
Bank deposits Giro, tabungan, deposito pada bank	*1,170.8*	*1,886.4*
Gross loans/facilities outstanding Pembiayaan yang diberikan kotor	*7,301.1*	*9,653.8*
./. Loan loss reserve ./. Penyisihan Penghapusan	*(127.9)*	*(180.8)*
= Net loans/facilities outstanding = Pembiayaan yg diberikan bersih	*7,173.2*	*9,473.0*
Net fixed assets Aktiva tetap setelah dikurangi	*217.2*	*203.6*
Other net assets Aktiva lain-lain Bersih	*526.3*	*733.3*
Total assets **Jumlah aktiva**	***9,480.7***	***12,554.2***
Savings and deposits of clients Simpanan	*5,038.1*	*6,039.9*
Deposits of banks Simpanan dari bank lain	*600.0*	*1,001.5*
Borrowing Pinjaman	*1,655.3*	*3,022.7*

Balance sheet	2002 (unaudited)	2003 (audited)
Unpaid taxes Hutang pajak	*109.1*	*120.0*
Other liabilities Kewajiban lain-lain	*83.8*	*131.3*
Total liabilities **Jumlah kewajiban**	***7,488.9***	***10,318.0***
Paid-up capital Modal ditempatkan dan disetor penuh	*1,494.5*	*1,521.5*
Earnings (retained and current) Laba (tahun lalu dan berjalar)	*497.3*	*714.8*
Total equity **Jumlah ekuitas**	***1,991.8***	***2,236.3***
Total liabilities and equity **Jumlah kewajiban dan ekuitas**	***9,480.7***	***12,554.2***

Income statement	**Million Rp**
Gross income from financial operations Pendapatan marjin, bagi hasil, provisi, komisi	2,231.8
./. Interest or profit-sharing expenses *./. Beban marjin dan bagi hasil*	(861.4)
= Net income from financial operations *= Jumlah pendapatan marjin dan bagi hasil*	1,370.4
+ Other operational income *+ Jumlah pendapatan operasional lainnya*	161.8
./. Other operational expenses *./. Jumlah beban operasional lainnya*	1,157.8
Personnel expenses in % *Beban personalia di %*	53.9%
Loan loss provisions (included above) *Penyusutan dan penyisihan (di dalam)*	(126.9)
= Operational profit *= Laba operasional*	374.4
./. Non-operational expenses *./. Beban non-operasional*	7.7
= Gross profit (loss) *= Jumlah laba (rugi)*	366.7
./. Religious tax *./. Zakat*	9.0
./. Other expenses *./. Beban pajak penghasilan*	89.8
Net profit (loss) *Laba bersih (rugi)*	267.9

Performance	2001	2002	2003
Loan recovery			
NPL, NPF in %			11
Loans written off in million Rp	0	0	5m
Loan loss ratio in %	0	0	3
Profitability			
Return on average assets in %	4.07	3.65	3.35
Return on average equity in %	20.32	21.05	24.10
Ratios	**2001**	**2002**	**2003**
Equity/liabilities in %		26.6	21.7
Deposits/liabilities in %		67.3	58.5
LDR, FDR in %	85.32	88.58	86.72
CAR in %	22.99	21.74	20.86
OCR BOPO Operational costs to revenue	82.79	86.50	84.71

Appendix 5: Islamic cooperatives

Table 1: Basic data on KSP/USP, December 2002 and December 2003

	KSP/USP sector 2002	KSP/USP sector 2003	Mean per KSP/USP 2003
Number of KSP/USP	36,532	36,376	
Number of members	10,514,624	10,420,582	286
Total assets	6,792.7 billion Rp	6,197.1 billion Rp	170.4 million Rp
Loans outstanding	5,551.3 billion Rp	5,273.6 billion Rp	145.0 million Rp
Deposits	1,500.8 billion Rp	1,593.4 billion Rp	43.8 million Rp

Source: MoC, Perkembangan KSP/USP Koperasi Seluruh Indonesia, 2004

Table 2: Year of origin, members and number of board members in four BMT

BMT	Year of origin and registration	No. of members	No. of board members
1 At-Taqwa	1994/2000	4000	14
2 Ibaadurrahman	1992/1992	3000	3
3 Latanza	1996/2000	800 in 80 KSMs 20 KSMs active as borrowers 60 savings groups only	8
4 Wira Mandiri	1997/1999	45 voting members 2,000 partnerships without voting rights	4

Table 3: Regional distribution of BMT, 2001 and 2003*

Province		BMT 2001		BMT 2003		KSP/USP
		Number	Percent	Number	Percent	Percent
Java		1980	65.2	1705	59.7	54.1
	Jakarta	165		110		
	West Java + Banten	637		494		
	Central Java	513		539		
	D.I. Yogyakarta	65		76		
	East Java	600		486		
Sumatra		496	16.3	572	20.0	17.6
	Nangroe Aceh Dar.	76		76		
	North Sumatra	156		199		
	West Sumatra	60		60		
	South Sumatra	65		70		
	Lampung	42		43		
	Bengkulu	20		20		
	Riau	65		92		
	Jambi	12		12		
	Kep. Bangka Bel.	0		0		
Sulawesi		340	11.2	357	12.5	9.2
	North Sulawesi	62		62		
	Central Sulawesi	11		11		
	Sulawesi Tenggara	23		23		
	South Sulawesi	244		261		
	Gorontalo	0		0		
Kalimantan		66	2.2	66	2.3	10.2
	West Kalimantan	15		15		
	Central Kalimantan	10		10		
	East Kalimantan	24		24		
	South Kalimantan	17		17		
Bali		15	0.5	15	0.5	2.7
West Nusa Tenggara (NTB)		93	3.1	93	3.3	2.1
East Nusa Tenggara (NTT)		8	0.3	8	0.3	1.7
Maluku and Maluku Utara		21	0.7	21	0.7	1.2
Papua		18	0.6	19	0.7	1.2
Total number		**3037**		**2856**		**40,639**
Total percent			**100.1****		**100.0**	**100%**
Change 2001-2003				*-6.0%*		

*Source: (a) BMT: PINBUK statistics for December 2001, manually corrected for December 2003.
(b) KSP/USP: MoC, Rekapitulasi Pemetaan KSP/USP, 13 April 2004.
** Error due to rounding.

Table 4: Numbers of staff, loan officers and service radius in four BMT

BMT	Number of staff	Loan officers		Service radius in km
		Number	% of staff	
1 At-Taqwa	10	5	50	20
2 Ibaadurrahman	9	2 loan officers + 4 collectors	67	5
3 Latansa	4	2	50	10
4 Wira Mandiri	5	2	40	20
Average (mean)	7	3.75	40	13,75

Table 5: Composition of clientele of four BMT

BMT	Total no. of clients	% small traders & micro-entrepreneurs	% farmers	% salaried	% other: ________	% women	% below poverty line
1 At-Taqwa	4,000	99	0	1	0	45	60
2 Ibaadurrahman	2,500	100	0	0	0	50	70
3 Latansa	800	100	0	0	0	40	30
4 Wira Mandiri	2,000	85	5	10	0	30	20
Average	2,325	96	1	3	0	41	45

Table 6: Number of borrowers in four sample BMT

BMT	Total no. of borrowers
1 At-Taqwa	500
2 Ibaadurrahman	300
3 Latansa	200
4 Wira Mandiri	308
Average	327

Table 7: Selected balance sheet data of four BMT (in million Rp)

BMT	Total assets	Gross loan portfolio	Total deposits	FDR in %
1 At-Taqwa	2,211.2	1,819.4	1,957.9	93
2 Ibaadurrahman	341.4	217.2	199.3	109
Latansa	501.1	345.8	137.15	252
4 Wira Mandiri	806.4	587.3	575.8	102
Average (mean)	965.0	742.4	717.5	103

Table 8: Deposit products in four BMT

BMT	Total amount (in million Rp)	Number of products	Savings accounts		Time deposit accounts	
			Revenue-sharing Client-BMT	*Average return in % p.a.*	*Revenue-sharing Client-BMT*	*Return in % p.a.*
At-Taqwa	1,957.9	5	35:65 40:60	9.0 9.6	45:55	13.2
Ibaadurrahman	199.3	4	25:75	5	35:65 40:60 45:55	~12
Latanza	137.15	4	40:60	11	40:60	14-16%
Wira Mandiri	575.8	5		10		14
Mean	*717.5*	*4.5*	*34:66*	*8.8*	*42:58*	*13.6*

Table 9: Loan products in four BMT

BMT	Amount (in mn Rp)	No. of accounts	No. of products	Loan products as a % of portfolio			
				Murabahah	Mudarabahh	Qard Al-Hassan	Other
At-Taqwa	1,819.4	500	4	70	15	6	10
Ibaadurrahman	217.2	300	2	51	44	2	3
Latanza	345.8	200	2	33	61	6	
Wira Mandiri	587.3	308	4	92	8		0
Unweighted mean	742.4	327	3	61.5	32	3.5	3

Murabahah financing deals start at around Rp 100,000 in two sample BMTs, and Rp 1mn in another two; maximum loan sizes range from 3 to 30 million in the four BMTs. Minimum loan periods range from one to three months, maximum loan periods range from 10 to 36 months. Instalments are usually monthly or weekly; BMT Wira Mandiri also allows for daily installment collection. Mark-ups are negotiated between the BMT and the customer and are thus variable, sometimes by a wide margin. Effective mark-ups p.a., comprising a flat rate per month and an upfront administrative fee, range from approximately 38% to 66%; they are mostly above 50% p.a.

Mudarabah financings in the four sample BMT start at loan sizes ranging from Rp 100,000 to 5mn; maximum loan sizes range from Rp 5mn to 25mn. Minimum loan periods range from 1-12 months, maximum loan periods range from 10 to 24 months. Instalments, as in *Murabahah*, are usually monthly or weekly and also daily in BMT Wira Mandiri. It appears that BMT, unlike BPRS, are unable to calculate variable profit-sharing margins; instead, they charge mark-ups identical to those in *Murabahah*. An exception is BMT Latanza, which charges the mark-up on a declining balance, but levies a higher administrative fee; the effective charge is approximately 35% p.a.

Three of the four BMT offer *Qard Hasan* at no remuneration to new micro-entrepreneurs; repayment is expected but not enforced. Loan sizes are small, mostly between Rp 100,000 but also even 50,000 and up to 1 million. BMT At-Taqwa also offers a variant, *Qard*, where repayment is enforced and loan sizes are somewhat larger at around Rp 0.5-2.0m.

Three of the BMT charge no penalties in case of late payments; BMT Latanza negotiates penalties with the customer, arriving on average at an extra monthly charge of 2.5%.

The terms and conditions of financing in BMT At-Taqwa, the largest of the four sample BMT, are presented below. The portfolio includes two unremunerated financing products for start-up micro-entrepreneurs: *Qard*, accounting for 10% of the portfolio where repayment is enforced and collateral seized if necessary; and *Qard Hasan*, accounting for 5% of the portfolio, which is repayable but no action is taken in case of default. There are compulsory savings of 5% in *Murabahah*, which have to be deposited upfront, and in *Qard*, where they are deposited at the time of disbursement (but not interpreted as “deducted”).

Table 10: Financing terms and conditions of BMT At-Taqwa

	Loan products			
	1: Murabaha	**2: Mudarabahh**	**3: Qard Al-Hassan**	**4: Qard**
Portfolio	70%	15%	5%	10%
Number of borrowers	80%	4%	6%	10%
Minimum loan size in Rp million	1	5	0.1	0.5
Maximum loan size in Rp million	25	25	1	2
Profit-sharing margins:				
Nominal (flat)	18-24%	18-24	0	0
Fees if any	1.5%	1.5	0	0
Effective p.a. (approx.)	38-50%	38-50%	0%	0%
Profit-sharing vs. interest rates	A fair system			
Admin. fee for late payment	0	0	0	0
Minimum loan period in months	3	12	3	3
Maximum loan period in months	36	24	12	12
Installment schedule	M	M	M	M
Collateral/guarantee requirements	Yes	Yes	No	No
Loan size tied to savings?	10%	No	5-10%	5-10%

Table 11: Non-performing loans and return on year-end assets in four BMT, 2003 (in %)

BMT	*NPL*	*ROA (yr-end)*
At-Taqwa	1.9	2.7
Ibaadurrahman	10	1.45
Latanza	1.4	1.7
Wira Mandiri	30	0.16

BMT At-Taqwa is the largest and apparently best-performing BMT of the four sample cases, with a year-end ROA of 2.7% and an ROE (on paid-in capital) of 49%. Its balance sheet, income statement and performance ratios are given below. BMT Ibaadurrahman, with an ROA of 1.45, has reported that its total assets have more than doubled from Rp 150m to 341m in the year since it moved to its new location near the local market. The performance of BMT Latanza is satisfactory, but seems to be contingent upon donations and soft loans from the government.

One poorly performing BMT was purposely included in the sample, namely BMT Wira Mandiri, which reports a breakeven ROA of 0.16% for 2003, but is technically bankrupt. The manager reports massive delays and defaulting, which he attributes to a lack of knowledge and experience of management; high management turnover; weak controls by inexperienced supervisors; weak compliance with sharia; a lack of observance of prudential norms; and a conflict of interest in lending resulting in so-called buddy loans. For example, the portfolio includes an investment of Rp 40.4m in a dental clinic and a return of Rp 1.36m or 3.4% during 2003, which is below the inflation rate. The BMT's NPL ratio is estimated at 30%. Rp 30m has to be written off. Provisioning is inadequate: Rp 4.15m in the balance sheet and Rp 1.5m in the income statement of 2003. The

profit of Rp 1.26m in the balance sheet is thus grossly misleading. With a capital of Rp 26.8m and a volume of bad debts to be written off of Rp 30m, the BMT is technically bankrupt.

Table 12: Balance sheet, income statement and performance ratios of BMT At-Taqwa, 31 December 2003 (Amounts in million Rp)

Balance sheet	**2003**
Cash at hand Kas	*2.9*
Bank deposits Giro, tabungan, deposito pada bank	*406.7*
Gross loans/facilities outstanding Pembiayaan yang diberikan kotor	*1,819.4*
./. Loan loss reserve ./. Penyisihan Penghapusan, PYD	*(80.0)*
= Net loans/facilities outstanding = Pembiayaan yg diberikan bersih	*1,739.4*
Net fixed assets Harta tetap setelah dikurangi	*49.4*
Other net assets Aktiva lain-lain Bersih	*12.8*
Total assets **Jumlah aktiva**	***2,211.2***
Savings and deposits of clients Simpanan	*1,957.9*
Donations from social institutions *Baitul Maal*	*1.4*
Borrowing (from shareholders) Pinjaman	*64.2*
Other liabilities Kewajiban lain-lain	*1.5*
Total liabilities **Jumlah kewajiban**	***2,025.0***
Paid-up capital Modal dasar	*120.0*
Social funds for employees Cadangan	*7.5*
Retained earnings Laba tahun lalu	*0.0*
Profit of current year Laba tahun berjalan	*58.7*
Total equity **Jumlah ekuitas**	***186.2***
Total liabilities and equity **Jumlah pasiva**	***2,211.2***

Income statement	2003
Income (*Pendapatan)*	
Income from financial operations *Pendapatan marjin, bagi hasil, provisi, komisi*	509.4
+ Other operational income *+ Jumlah pendapatan operasional lainnya*	40.1
Total income ***Total pendapatan***	**549.5**
Expenditure (*Biaya-biaya*)	
./. Interest or profit-sharing expenses *./. Beban marjin dan bagi hasil*	199.0
./. Other operational expenses *./. Jumlah beban operasional lainnya*	262.8
Personnel expenses: amount *Beban personalia:*	196.6
Personnel expenses in % *Beban personalia di %*	74.8%
Loan loss provisions (included above) *Penyusutan dan penyisihan (di dalam)*	29.0
Total expenditure *Total biaya*	**490.8**
Net profit (loss) ***Laba bersih (rugi)***	**58.7**

Performance	2003
Loan recovery	
NPL, NPF in %	1.9
Loans written off in million Rp	0
Loan loss ratio in %	0
Profitability	
Return on year-end assets in %	2.7
Return on year-end earning assets in %	3.2
Return on paid-in equity in %	48.9
Ratios	
Equity/liabilities in %	5.9%
Deposits/liabilities in %	96.7
LDR, FDR in %	92.9
CAR in %	6.9
Efficiency	
Number of active borrowers per loan officer	100
BOPO Operational costs-to-revenue	89.3
Value of loans outstanding per loan officer in million Rp	363.8